FILED
03 776 NOV 20 2003
OFFICE OF THE CLERK

No. 03-___

In The

Supreme Court of the United States

FRANCHISE TAX BOARD,

Petitioner,

v.

FARMER BROS. CO.,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The Second Appellate District

PETITION FOR A WRIT OF CERTIORARI

JOHN W. DAVIES, Chief Counsel
BENJAMIN F. MILLER, Counsel, Multistate Tax Affairs
(*Counsel of Record*)
KARL W. GROSSENBACHER, Sup. Tax Counsel
CRAIG A. SWIESO, Tax Counsel
CALIFORNIA FRANCHISE TAX BOARD
Post Office Box 1720
Rancho Cordova, CA 95741-1720
(916) 845-3320 Fax: (916) 845-3648

Attorneys for Petitioner
California Franchise Tax Board

COCKLE LAW BRIEF PRINTING CO. (800) 225-6964
OR CALL COLLECT (402) 342-2831

64 pp

QUESTION PRESENTED FOR REVIEW

Section 24402 of the California Revenue and Taxation Code relieves California's double taxation of California corporate income by allowing corporations to deduct dividends received when the income from which the dividends were paid was previously taxed by California. The question presented is whether a deduction, granted to relieve a burden that only intrastate commerce bears, discriminates against interstate commerce in violation of the dormant Commerce Clause?

PARTIES TO THE PROCEEDING

The parties to the proceeding are:

FRANCHISE TAX BOARD, an agency of the State of California charged with the administration of the California Corporation Tax Law, sections 23001-25141, of the California Revenue and Taxation Code.

FARMER BROS. CO., a publicly-traded California corporation. Petitioner is unaware of any parent company or nonwholly-owned subsidiaries of respondent.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED FOR REVIEW	i
PARTIES TO THE PROCEEDING	ii
PRAYER	1
OPINIONS BELOW	1
BASIS FOR SUPREME COURT JURISDICTION	1
CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	2
REASONS FOR GRANTING WRIT	6
A. Whether the Dormant Commerce Clause Requires a State to Extend a Deduction to Interstate Commerce, Because It Grants a Deduction Tailored to Relieve a Burden Borne Only by Intrastate Commerce, Is an Important Question Involving Our System of Federalism and the Legislative Options of the States to Relieve Burdens on Intrastate Commerce	6
B. The States Need Direction as to the Permissible Contours of a Compensatory Tax	13
1. The Compensatory Tax Defense	13
2. The Decisions of This Court Have Not Addressed the Question of Whether the Compensatory Tax Defense Has Application When a Single Levy Is Involved	15

TABLE OF CONTENTS – Continued

Page

3. This Court Has Not Answered the Question of Whether a Tax on a Corporation Is Sufficiently Equivalent to a Tax on the Dividend Income Received by Shareholders of the Corporation to Satisfy the Requirements of the Compensatory Tax Defense 16

4. Errors in the California Court of Appeal's Analysis 17

5. The California Dividends-Received Deduction Meets the Requirements of the Compensatory Tax Defense When It Is Correctly Applied 21

CONCLUSION 23

TABLE OF AUTHORITIES

Page

CASES

Associated Indus. of Mo. v. Lohman, 511 U.S. 641 (1994) 6

Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994) 7

Butler Bros. v. McColgan, 315 U.S. 501 (1941) 7

Camps Newfound/Owatonna v. Town of Harrison, 520 U.S. 564 (1997) 14

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) 6

Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983) 7, 11

D.D.I. Inc. v. State, 657 N.W. 2d 228 (N.D. 2003) 13

Fulton Corp. v. Faulkner, 516 U.S. 325 (1996) ..... *passim*

Goldberg v. Sweet, 488 U.S. 252 (1989) 12

Henneford v. Silas Mason Co., 300 U.S. 577 (1937) 6, 15

Maryland v. Louisiana, 451 U.S. 725 (1981) 15

Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980) 7, 11

Oregon Waste Systems, Inc. v. Dep't of Environmental Quality of Or., 511 U.S. 93 (1994) ..... *passim*

Rosemary Properties v. McColgan, 29 Cal. 2d 677 at 688-89 (1947) 9

Safeway Stores, Inc. v. Franchise Tax Bd., 3 Cal. 3d 745 (1970) 9

Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232 (1987) 15

Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940) 7

TABLE OF AUTHORITIES – Continued

Page

CONSTITUTIONAL AND STATUTORY PROVISIONS

U.S. Const. art. 1, § 8, cl. 1 and 3 2

26 U.S.C. § 61(a)(7) 8

26 U.S.C. § 243 8

28 U.S.C. § 1257(a) 1

28 U.S.C. § 2101(c) 1

California Rev. & Tax. Code § 23001 2

California Rev. & Tax. Code § 23151 9

California Rev. & Tax. Code §§ 24271, 24401 and 24402 ..... *passim*

California Rev. and Tax. Code §§ 25120-25141 7

OTHER AUTHORITIES

W. Hellerstein, "*Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*," 39 Tax Lawyer 405 (1986) 22

PRAYER

The California Franchise Tax Board ("FTB") respectfully petitions that a Writ of Certiorari be issued to the Court of Appeal of the State of California (Second Appellate District, Division One) in this case.

OPINIONS BELOW

The Opinion of the Court of Appeal below (App. A, *infra*) is reported at 108 Cal. App. 4th 976 (Second Appellate District, Division One, May 21, 2003).

BASIS FOR SUPREME COURT JURISDICTION

The Court of Appeal of the State of California, Second Appellate District, Division One, entered its decision on May 21, 2003. Petitioner, the California Franchise Tax Board, seeks review of that decision on a writ of certiorari.

On July 1, 2003, the California Franchise Tax Board filed a timely Petition for Review with the California Supreme Court. On August 27, 2003, the California Supreme Court filed an order denying the Petition for Review (App. D, *infra*). The present petition is timely filed under 28 U.S.C. § 2101(c) and Rule 13.3 of this Court.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. 1, § 8, cl. 1 and 3, provides:

> The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

Pertinent portions of the California taxing statutes (California Rev. & Tax. Code §§ 24271, 24401 and 24402) appear in Appendix F.

STATEMENT OF THE CASE

For the years 1992 through 1998, Farmer Bros. Co. ("Taxpayer") filed California corporate income tax returns claiming a "dividends-received deduction" under section 24402 of California's Revenue and Taxation Code.[1] That section provides corporations with a deduction[2] for dividends received that are declared from "income which has been included in the measure of the taxes imposed" under the California Corporation Tax.[3] Section 24402 has been

[1] Unless otherwise indicated, all "section" references refer to sections of California's Rev. & Tax. Code.

[2] The deduction is allowed in varying portions (percentages) depending upon the percentage of ownership the dividend-recipient corporation has in the dividend-paying corporation. This limitation is not at issue in this case and is therefore ignored for purposes of the Petition.

[3] California Rev. & Tax. Code § 23001 and following.

an integral part of the Revenue and Taxation Code from the date the Corporation Tax was enacted in 1929.[4]

On its originally-filed returns, Taxpayer limited its section 24402 deduction, as required by that section, to the dividends that it received from corporations whose income had already been subjected to tax by California. Taxpayer subsequently filed amended tax returns (i.e., claims for tax refund) claiming that section 24402's limitation upon the dividends-received deduction to dividends attributable to income that already had been subjected to the California Corporation Tax was unconstitutional under the Commerce Clause of the United States Constitution because it discriminated against interstate commerce. Therefore, Taxpayer claimed it was entitled to a deduction under section 24402 with respect to *all* of the dividends it received.

Taxpayer exhausted its administrative remedies and commenced a tax refund suit in the Superior Court of the County of Los Angeles, California. In its complaint, Taxpayer alleged that section 24402 was unconstitutional because it discriminated against interstate commerce in violation of the Commerce Clause of the United States Constitution by granting a deduction only with respect to dividends that were paid from income previously subject to California tax.[5] The Franchise Tax Board ("FTB") filed an

---

[4] It then appeared as section 8(h), Ch. 13, Stats 1929, p. 23.

[5] Taxpayer's initial and amended complaints also included allegations of violations of other provisions of both the California and United States Constitutions, all of which were stricken by the trial court early in the proceedings on motion of the Franchise Tax Board.

answer, denying that the deduction resulted in discrimination against interstate commerce and alleging that in the event the deduction was found to be facially discriminatory, it nevertheless met the requirements of this Court's "compensatory tax defense" and therefore should be sustained against Taxpayer's constitutional challenge.

The matter came to trial on October 25, 2001, at which time the parties filed opening trial briefs, a joint stipulation of agreed facts, and interrogatories propounded by the Taxpayer and FTB's response to those interrogatories. FTB proffered a witness list of two professors, one an economist and one an expert in tax policy, who would testify to presence of the factual predicates of the compensatory tax defense. Taxpayer filed a motion *in limine* to bar the testimony of the proffered witnesses. The parties agreed to bifurcation of the trial. The trial court was first to consider and rule upon the Commerce Clause issue. If the trial court determined that the statute was constitutionally infirm, a second proceeding would be held to determine the relief to be granted to the Taxpayer.

After reviewing the submitted materials, the trial court, on November 21, 2001, issued its ruling in a minute order, concluding that section 24402 "facially places an unconstitutional burden on interstate commerce" (App. E, *infra*). The trial court denied the Taxpayer's motion *in limine* as moot.

FTB filed an application for an extraordinary writ with the Court of Appeal, arguing that the trial court erred: 1) in finding that section 24402 discriminated against out-of-state interests; 2) in finding that the requirements for a constitutionally permitted compensatory tax were not met; and 3) by failing to deny the Taxpayer's

motion *in limine* on the merits. The application for the writ was denied on March 7, 2002 (App. C, *infra*).

Briefs were filed on the remedy issue. The trial court thereafter ordered that the requested refunds be granted. Judgment was entered on May 13, 2002 (App. B, *infra*).

FTB filed a timely notice of appeal on the Commerce Clause issue. FTB argued: 1) that section 24402 did not discriminate; and 2) that even if section 24402 was facially discriminatory, it was saved by application of this Court's compensatory tax defense.

The trial court's decision (App. B, *infra*) was affirmed by California's Second District Court of Appeal, which held that: 1) section 24402 was facially discriminatory because "it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California," and 2) the disparate treatment provided to previously taxed-in-California income versus previously untaxed-in-California income was not justified as a compensatory tax enactment under the applicable precedents of this Court (*Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) (*Fulton*) and *Oregon Waste Systems, Inc. v. Dep't of Environmental Quality of Or.*, 511 U.S. 93 (1994) (*Oregon Waste*)).

FTB timely filed a Petition for Review with the California Supreme Court. On August 27, 2003, the Petition for Review was denied by the California Supreme Court without comment (App. D, *infra*).

REASONS FOR GRANTING WRIT

A. Whether the Dormant Commerce Clause Requires a State to Extend a Deduction to Interstate Commerce, Because It Grants a Deduction Tailored to Relieve a Burden Borne Only by Intrastate Commerce, Is an Important Question Involving Our System of Federalism and the Legislative Options of the States to Relieve Burdens on Intrastate Commerce.

The decisions of this Court have long held that the dormant Commerce Clause prohibits a State from legislating in a manner that gives an advantage to intrastate commerce over interstate commerce. *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977). This Court has also made clear that the dormant Commerce Clause is not violated if state legislation treats intrastate and interstate commerce equivalently. *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641 (1994); *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937). There are no decisions of this Court, however, holding that the dormant Commerce Clause requires a State to *disadvantage* intrastate commerce as compared to interstate commerce by requiring intrastate commerce to bear a burden that interstate commerce does not. That is the question that this case presents, and it is one that this Court should answer to define permissible legislative action.

California has exercised its right to tax corporate income that is fairly and properly attributable to California in a manner consistent with the constraints established by the United States Constitution (specifically the Due Process Clause of the Fourteenth Amendment and the Commerce Clause). This Court has approved California's application of the unitary business principle, including the

use of combined reporting and the business-nonbusiness characterization of income pursuant to the Uniform Division of Income for Tax Purposes Act,[6] to assess corporate franchise and income taxes. *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994); *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Butler Bros. v. McColgan*, 315 U.S. 501 (1941). Under this approach, California may consider the activities of a unitary business, and the income generated by those activities, that occur without its borders, but California *only* taxes the income that is properly attributed to California.

California exercises its right to include dividends in the corporate income base subject to tax.[7] California, however, also has recognized that by requiring dividends to be included in the corporate tax base, it has created double (or even multiple) taxation of such income at the corporate level *when* the dividends are paid from income that was previously taxed by California in the hands of the dividend-paying corporation.[8] The income is first taxed

---

[6] Sections 25120-25141, California Rev. & Tax. Code.

[7] Section 24271, California Rev. & Tax. Code. The right of a State to consider and tax dividend income, regardless of the relationship of the dividend-paying corporation to the State, has long been recognized by this Court. *E.g.*, *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980); *Wisconsin v. J.C. Penney Company*, 311 U.S. 435 (1940). Taxpayer does not contest the fact that California can tax the dividends at issue in this case. The taxpayer only claims that if California chooses to forego tax with respect to some dividends (those paid from income that California has previously taxed), California must forego taxing *all* dividends.

[8] As the phrases are used herein, "double taxation" or "multiple taxation" refers to the taxation of the income of a corporation followed by taxation of the same income when it is paid by that corporation as a dividend to a shareholder corporation and taxed again in the hands of that shareholder corporation.

when the dividend-paying corporation earns income from its business operations attributable to California. The California income, but for section 24402, would be subject to tax a second time (and potentially multiple times after that) when it is distributed as a dividend to a corporation that is a California taxpayer. The practice of taxing dividends, despite the double taxation of income at the corporate level when the dividend is received by another corporation, is a well-established practice under both State and federal law (see 26 U.S.C. § 61(a)(7), incorporated by reference by California under section 24271). Such taxation does not give rise to constitutional concerns.

Nevertheless, both the federal government and California have chosen, as a matter of *tax policy*, to reduce the double corporate tax burden imposed in such situations. At the federal level, Congress has provided limited relief from the double corporate taxation of dividends by the dividends-received deduction of 26 U.S.C. § 243; at the state level, California has provided comparable limited relief by the dividends-received deduction of section 24402. The operation of the two statutes is similar. Both statutes, in general, grant relief to corporate shareholders only as to dividends received from corporations whose earnings *already have been subject to tax by the taxing jurisdiction.* The federal dividends-received deduction permits a dividend recipient to deduct a portion of the dividends received "from a domestic corporation which is subject to taxation under this chapter." 26 U.S.C. § 243(a). The corresponding California provision, section 24402, provides relief with respect to "dividends received . . . from income which has been included in the measure of the taxes imposed" upon the taxpayer declaring the dividends.

It was in furtherance of these well-established tax principles that California, in 1929, adopted the predecessor to section 24402 when it first enacted its Corporation Tax. As recognized by the California Supreme Court, "The purpose of [the dividends-received deduction] is to avoid double taxation at the corporate level of income which has already been subject to California taxation in the hands of the dividend-declaring corporation." *Safeway Stores, Inc. v. Franchise Tax Bd.*, 3 Cal. 3d 745, 750 (1970); *Rosemary Properties v. McColgan*, 29 Cal. 2d 677 at 688-89 (1947) (Traynor, dissent).

The operation of the deduction is illustrated by the following simplified[9] examples:

1) A dividend-payor, Corporation A, earned $100 that was taxed by California. Its California tax on this income is $8.84 ($100 multiplied by the current statutory rate of 8.84%).[10] Corporation A pays a dividend of the after-tax income, $91.16 ($100-$8.84), to Corporation B. Corporation B receives $91.16 of income. But for section 24402, Corporation B would pay a tax of $8.06 on the receipt of the dividend ($91.16 of income multiplied by the statutory rate of 8.84%). However, section 24402 allows Corporation

[9] The examples were constructed without taking into account either the percentage limitation related to ownership or that the income of both the dividend-paying and dividend-receiving corporation may be determined on an apportioned basis so that something less than 100% of their incomes would be taxed by California. These facts would add unnecessary complexity to the examples but would not change the essential relationships.

[10] Section 23151, California Rev. & Tax. Code.

B to take a deduction of $91.16 with respect to the dividend. Because of the deduction, Corporation B pays no California tax on the dividend. California receives a total tax of $8.84 on the $100 of income earned by Corporation A and paid to Corporation B.

2) A dividend-payor, Corporation C, earned $100 that is not taxed by California. A dividend is paid of the after-tax income, $100.00, to Corporation D. Corporation D receives $100.00, which is taxed by California at the statutory rate of 8.84%, and pays California a tax of $8.84. Corporation D does not receive a deduction under section 24402 because the income from which the dividend was paid was not previously taxed by California. Corporation D has after-tax income of $91.16. California receives a total tax of $8.84 on the $100 of income earned by Corporation C and paid to Corporation D.

As these two examples illustrate, California, because of section 24402, has asserted a single tax of $8.84 on the same $100 of income. The after-tax income of the dividend recipient is the same in both circumstances, $91.16. But for section 24402, in example 1 California would receive a total tax of $16.90 on the $100 of income earned by Corporation A and paid to Corporation B, and Corporation B would have after-tax income of only $83.10. California, by allowing a dividends-received deduction, has avoided taxing this income twice. To the extent that California has not taxed the income of the dividend-paying corporation because it is sourced outside of California, there is no California double taxation; therefore, there is no burden on interstate commerce created by California, and no need to provide relief. In example 2 above, if California were to

extend the dividends-received deduction to *all* dividend income regardless of whether California had previously taxed the income from which the dividend was paid, as required by the ruling of the California Court of Appeals below, the corporate recipient of the dividend would have $100 of after-tax income attributable to California and California would receive no tax. In contrast, as illustrated in example 1, intrastate commerce would have paid a tax of $8.84 if no dividend deduction were allowed with respect to income that California has not previously taxed. Discrimination against intrastate commerce would be the result.

The decision of the California Court of Appeal that section 24402 discriminates against interstate commerce is without any logical foundation or judicial support because that section creates no burden on interstate commerce. California can only tax California income; it does not tax income attributable to other states. The taxation of dividend income at the corporate level gives rise to the burden of California double taxation only when California has previously taxed that income.[11] If a dividend received by a California corporate taxpayer is paid from income that has not been taxed by California, there is no California double-taxation burden to relieve.

The inequity created by the holding below is compounded because, not only is there no discrimination

---

[11] Under this Court's decisions and the Due Process Clause of the Fourteenth Amendment, California can, and does, tax only California income. *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980); *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

against interstate commerce, but the denial of the deduction actively *creates* discrimination against California intrastate commerce. Without the section 24402 deduction, California taxes the same intrastate income twice. It is one thing to hold that the Commerce Clause does not protect intrastate commerce from discrimination, *Goldberg v. Sweet*, 488 U.S. 252 (1989), but it is a far different, and novel, proposition to hold that the Commerce Clause *affirmatively requires* such discrimination.

The holding of the California Court of Appeal has broad and important implications for state tax policy and our federalism. In the context of laws that apply both to interstate and intrastate commerce, if States cannot act to remove, or limit, the burdens on intrastate commerce that they have created, intrastate commerce will not be on an equal footing with interstate commerce.[12] States will be hamstrung in their efforts to ensure that intrastate and interstate commerce each pays its fair share, and no more than its fair share, of the cost of an ordered society. The decisions of this Court applying the Commerce Clause to State taxes and State tax deductions do not require the result reached by the Court below. Only this Court can provide the necessary guidance with respect to its Commerce Clause decisions to correct the problem that can be caused by the decision of the California Court of Appeal.

---

[12] For example, most, if not all, States asserting a tax on or measured by income grant credits against those taxes. State corporate income taxes are determined by considering in-state and out-of-state activities (interstate commerce) in determining the in-state income. The credits, however, are allowed only with respect to intrastate activities.

B. The States Need Direction as to the Permissible Contours of a Compensatory Tax.

This case presents several questions that this Court has not previously addressed. The States need answers with respect to those questions. The California Court of Appeal has misapplied the decisions of this Court to find that California's dividends-received deduction does not meet the requirements of the compensatory tax defense. The Supreme Court of North Dakota also reached the same result with respect to a similar deduction granted by that state.[13] These erroneous decisions demonstrate the need for this Court's direction.

1. The Compensatory Tax Defense

This Court has held that a facially discriminatory[14] State tax is "virtually *per se*" invalid under the Commerce Clause. However, this Court's decisions also have held that a facially discriminatory tax is constitutional if it meets the requirements of the compensatory tax defense. *Fulton,, supra*, 516 U.S. at p. 331.[15] This Court has never held

---

[13] *D.D.I., Inc. v. State*, 657 N.W. 2d 228 (N.D. 2003).

[14] This Court has not specifically defined what a facially discriminatory State tax is, but it appears that a State tax that gives rise to differential tax treatment, based upon geographic (state and national) considerations, is facially discriminatory for dormant Commerce Clause analysis purposes. Section 24402 provides differential treatment based upon whether the income from which a dividend was paid was, or was not, previously included in the measure of the California Corporate tax. Under this definition, section 24402 is a facially discriminatory tax.

[15] This Court has *not* indicated that the compensatory tax defense is the only defense available to save a tax from a claim of facial discrimination. For example, in addition to showing that a tax does not have a discriminatory effect, this Court has stated that a

(Continued on following page)

that a State statute that satisfies the requirements of the compensatory tax defense is invalid.

This Court has set forth the following three-prong test to determine the applicability of the compensatory tax defense:

> (1) "[A] State that invokes the compensatory tax defense must identify the intrastate tax for which it seeks to compensate. . . ." *Fulton*, *supra*, 516 U.S. at p. 334;
>
> (2) "[T]he tax on interstate commerce [must] be shown roughly to approximate – but not exceed – the amount of the tax on intrastate commerce." *Id.*, at p. 336; and
>
> (3) "The compensating tax must fall on 'substantially equivalent events' to the tax for which it seeks to compensate." *Id.*, at p. 338.

Under that test, a tax (or tax deduction[16]) constitutes a valid compensatory tax enactment *despite* its apparent facial discrimination if it meets all three prongs of the test.

---

discriminatory tax can be saved if the State can show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564 (1997). The deduction at issue advances a legitimate local purpose, relief from double taxation, which cannot be achieved by a reasonable nondiscriminatory alternative.

[16] "That the tax discrimination comes in the form of a deprivation of a generally available tax benefit, rather than a specific penalty on the activity itself is of no moment." *Camps Newfound/Owatonna*, *supra*, 520 U.S. at pp. 578-579.

2. The Decisions of This Court Have Not Addressed the Question of Whether the Compensatory Tax Defense Has Application When a Single Levy Is Involved.

The compensatory tax defense is an analytical tool used by this Court to determine whether a facially discriminatory tax does not discriminate in fact. The prototypical application of the compensatory tax defense, or complementary tax defense,[17] is with respect to State sales and use taxes. *Henneford v. Silas Mason Co.,* 300 U.S. 577 (1937). Two different taxes were involved in *Silas Mason.* The States have unsuccessfully asserted the defense in other circumstances involving two different taxes. *E.g., Oregon Waste, supra* (the earning of income paired with the disposing of waste); *Fulton, supra* (a tax on intangibles paired with the earning of income); *Maryland v. Louisiana,* 451 U.S. 725 (1981) (a tax on the severance of natural resources paired with tax on the use of the resources); *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue,* 483 U.S. 232 (1987) (manufacturing and wholesaling of tangible goods).

This Court has not had occasion to consider whether the compensatory tax may be applicable in the context of a single tax. There is no reason, however, why it should not. The logic of the compensatory tax defense is equally applicable in the circumstance of a single tax as it is when there are two taxes involved. This case presents the opportunity for this Court to address the question of

---

[17] "We use the terms 'compensatory' tax and 'complementary' tax as two ways of describing the same phenomenon. . . . " *Fulton, supra,* 516 U.S. at p. 331, n2.

whether the compensatory tax defense is applicable in the circumstance of a single tax.

3. This Court Has Not Answered the Question of Whether a Tax on a Corporation Is Sufficiently Equivalent to a Tax on the Dividend Income Received by Shareholders of the Corporation to Satisfy the Requirements of the Compensatory Tax Defense.

A single tax, the California Corporation Tax, is at issue in this case. The same event, the earning of income (once as operating income and again as a dividend), is being taxed in the hands of both taxpayers. The amount of income the first taxpayer earns directly impacts upon the amount of dividends it can pay to the second taxpayer. Relief is granted to one taxpayer, the dividend-recipient corporation, because a tax has been imposed upon another taxpayer, the dividend-paying corporation. The California Court of Appeal held that the fact that two taxpayers were involved meant that the substantial equivalency prong of the compensatory tax defense was not met.

This Court has left the question of whether complementary taxes may be imposed on differently described taxpayers unanswered. The opportunity to consider this question was presented in *Fulton,* but it was not addressed. It was not addressed because of the number of other variables that were present that defeated the State's efforts to make a compensatory tax defense. The Court, however, recognized the existence of this question ("In principle, the door may be open for such an argument."

Fulton, supra, 516 U.S. at p. 341.) The policy reason for granting a dividends-received deduction is to relieve double taxation of the same income.[18] Under this justification, the fact there are two different taxpayers should not prevent the successful application of the compensatory tax defense. Because this case involves the single variable of two different taxpayers, this is the case in which that argument must be addressed.

4. Errors in the California Court of Appeal's Analysis

The California Court of Appeal, after determining that the deduction was facially discriminatory, limited its analysis of section 24402 to the application of the compensatory tax defense. The California Court of Appeal relied on two decisions of this Court, *Fulton* and *Oregon Waste,* where this Court found that the compensatory tax defense was inapplicable.

Fulton involved a property tax on the value of intangibles. In computing the State tax base, a deduction was allowed, based upon the extent to which the income of the issuer of the intangible was subject to income tax by the State. In *Fulton*, there were two separate taxes measured by two different values. The State attempted to establish

[18] To illustrate, if a corporate tax were not imposed on the dividend-paying corporation, its earnings and profits would be larger by the amount of the tax not paid. The resulting increase in earnings and profits could then be used to pay a dividend to the shareholders. Thus, the shareholders' pool of available dividends is exactly reduced by, and thus burdened by, the amount of tax that the corporation it owns was required to pay.

the requisite compensatory relationship between the two taxes by arguing that the funds generated by both taxes were used in regulating the securities industry within the State. This Court dismissed the justification as "unconvincing."[19] *Fulton, supra,* 516 U.S. at p. 335.

Oregon Waste involved a fee assessed for the disposal of waste that was generated outside of the State that was in excess of the fee charged for the disposal of waste generated within the State. The fees were used to fund the disposal of solid waste but were insufficient to meet all of the costs. The State's general revenues, including the income tax, were used to supplement the fees. The State attempted to invoke the compensatory tax defense to justify the higher fee charged out-of-staters on the basis that the out-of-staters were not subject to the State's income tax. The defense failed because there were two different measures for the levies; the fee on the out-of-state entity was calculated on a *per ton* basis, whereas the levy for which it was asserted to be compensating was the State's corporate tax measured by income.

For purposes of the compensatory tax defense analysis, this Court's decisions focus on three critical elements – the taxable event, the measure of the tax, and the tax rate. In the instant case, in contrast to *Fulton* and *Oregon*

---

[19] This Court also commented that its skepticism regarding the justification was "reinforced by the fact that the Secretary did not advance it [the cost of regulating the securities industry] to the state courts." *Fulton, supra,* 516 U.S. at p. 336, n.4. By way of contrast, California's justification for the compensatory tax defense, the relief of double taxation, is not after-the-fact. It has been advanced since 1929 when the deduction was first adopted by California.

Waste, a single tax is levied on the same event, at the same rate, and is used for the same purposes. In other words, this is not a "special tax to general tax" mismatch, but rather an exact match of general tax to general tax that is wholly contained within the same taxing system. This makes the comparisons involved in the compensatory tax defense simple and complete. The fact that a single tax is involved eliminates the complexities that this Court was concerned with in *Fulton* and *Oregon Waste.* The California Court of Appeal's decision does not focus on, and in fact ignores, the critical elements of this Court's analysis.

In analyzing whether the first and second prongs of the compensatory tax defense were met, the California Court of Appeal focused on the fact that the compensating taxes in *Fulton* and *Oregon Waste* were general levies, as is the compensating tax in this case. In spite of noting that this Court has stated that general levies are not necessarily inappropriate for use in the compensatory tax defense,[20] the California Court of Appeal found that the fact the section 24402 deduction occurred within a general levy meant that the necessary comparisons could not be made. The California Court of Appeal misconstrued this Court's comments to mean that a general levy could never be a compensating tax. It did not recognize that this Court's analysis was made in the context of comparing a general levy to a specific-purpose levy. It ignored the fact that the

[20] "While we need not hold that a State may never justify a compensatory tax by an intrastate burden included in a general form of taxation, the linkage *in this case* between the intrastate burden and the benefit shared by out-of-staters is far too tenuous to overcome the risk posed by recognizing a general levy as a complementary twin." *Fulton, supra,* 516 U.S. at p. 336 (emphasis added).

comparison in the case before it was occurring within a single tax system and therefore an identical levy was involved.

In applying this Court's precedents, the California Court of Appeal focused on the use of the proceeds of the levy. The California Court of Appeal interpreted this Court's decisions as meaning that a general revenue measure cannot be used as a compensatory alternative for a specific-purpose levy. Even if the California Court of Appeal's interpretation were correct, it is irrelevant for this case. In this case, a general levy is being used to compensate for the very same general levy.

Finally, the California Court of Appeal held that the income events at issue in section 24402 were not substantially equivalent by comparing them to *Fulton* and *Oregon Waste*. However, the facts in those cases are not comparable to the facts in this case. In *Fulton,* the events being taxed were the value of capital stock and the earning of income. In *Oregon Waste,* the events were the disposal of trash and the earning of income. In both cases, the events were of different types and the claim of substantial equivalency therefore was rejected. In the instant case, the incidence of tax with regard to both levies is the earning of income (once as operating income and again as a dividend); the events are equivalent. In finding that the events were not equivalent, the California Court of Appeal erroneously focused on the taxpayer and not on the event. The California Court of Appeal ignored the fact that in both circumstances the taxable *event* is the same – the earning of income that is subject to California tax.

5. The California Dividends-Received Deduction Meets the Requirements of the Compensatory Tax Defense When It Is Correctly Applied.

The California deduction satisfies the three prongs of the compensatory tax defense. The "intrastate tax" for which section 24402 compensates is the potential burden of California double taxation of corporate income from which a dividend was paid. As described above, California taxes only its apportioned and allocated share of the income the first time in the hands of the dividend-paying corporation when it earns income attributable to California. Without section 24402, California would tax the California-sourced income a second time, in the hands of the dividend recipient, when a corporation pays a dividend from income previously taxed by California to a corporation taxable in California. California compensates for this intrastate burden by allowing a dividends-received deduction to the extent the dividend is paid from income previously apportioned to and taxed by California. The compensation is equally available to corporations operating wholly within California and those that operate within and without the State.

Section 24402 satisfies the second, "roughly approximates" prong. In this instance, the "tax on interstate commerce" is the denial of a deduction to California corporate taxpayers to the extent that they receive dividends paid from income that was not previously subject to California taxation. California is providing relief solely with respect to the event that it would otherwise tax twice, the earning of income attributable to California. Both events are subject to the same tax at the same rate. The resulting tax on dividends paid from income not previously

taxed by California equals the amount of tax paid on income used to pay the dividends for which the deduction is allowed. Examples 1 and 2 (*ante,* pp. 10-11) show this. In example 1, Corporation B benefits from the section 24402 deduction while Corporation D in example 2 does not. But the after-tax income of the recipient, Corporation B in example 1 and Corporation D in example 2, is the same, $91.16. Because the "tax on interstate commerce" equals the "tax on intrastate commerce" it necessarily follows that the "roughly approximates" requirement is satisfied.

The third prong of the test requires that the interstate and intrastate taxes be on substantially equivalent events. "Substantial equivalency" does not require exact equivalency.[21] The receipt of income, whether it be operating income or the dividends therefrom, is the taxable event. Here the events being compared are at least substantially equivalent, if not identical.

All requirements of the compensatory tax defense are met. Therefore the California dividends-received deduction does not unconstitutionally discriminate against interstate commerce for Commerce Clause purposes.

---

[21] See W. Hellerstein, *"Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination,"* 39 Tax Lawyer 405, 431 (1986) ("the formal equivalence of one tax to another cannot be a criterion of complementarity").

CONCLUSION

Review of the California Court of Appeal's decision through a writ of certiorari will provide needed clarity to the teaching of this Court's decisions and will provide necessary guidance to the States in determining whether actions intended to relieve burdens on intrastate commerce result in constitutionally impermissible discrimination against interstate commerce.

Respectfully submitted,

JOHN W. DAVIES, Chief Counsel
BENJAMIN F. MILLER, Counsel, Multistate Tax Affairs
(*Counsel of Record*)
KARL W. GROSSENBACHER, Sup. Tax Counsel
CRAIG A. SWIESO, Tax Counsel

Attorneys for Petitioner California Franchise Tax Board

November 2003

APPENDIX A

Filed 5/21/03

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION ONE

FARMER BROS. CO., Plaintiff and Respondent, v. FRANCHISE TAX BOARD, Defendant and Appellant.	B160061 (Los Angeles County Super. Ct. No. BC237663)

APPEAL from a judgment of the Superior Court of Los Angeles County. Gregory C. O'Brien, Jr., Judge. Affirmed.

Bill Lockyer, Attorney General, W. Dean Freeman, Lead Supervising Deputy Attorney General, and Gregory S. Price, Deputy Attorney General, for Defendant and Appellant.

Anglin, Flewelling, Rasmussen, Campbell & Trytten, Robin C. Campbell; Morrison & Foerster, Thomas Hugh Steele and Amy L. Silverstein for Plaintiff and Respondent.

In this case of first impression, we hold that Revenue and Taxation Code section 24402 (section 24402), known as the "dividends received deduction," violates the commerce clause of the United States Constitution (commerce

clause) by discriminating against corporations engaged in interstate commerce.[1] Section 24402 affords to a corporate taxpayer an income tax deduction for a portion of the dividends it receives from another corporation when the dividends are declared from income which was included in the payer corporation's measure of California franchise tax, alternative minimum tax, or corporation income tax.[2] In holding that section 24402 violates the commerce

---

[1] The commerce clause provides that "Congress shall have Power . . . [¶] To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." (U.S. Const., art. 1, § 8, cl.3.)

[2] Before 2000, former section 24402 provided a deduction in computing taxable income for "[a] portion of the dividends received during the income year declared from income which has been included in the measure of the taxes imposed under Chapter 2 . . . [corporation franchise tax], Chapter 2.5 . . . [alternative minimum tax], or Chapter 3 . . . [corporation income tax] upon the taxpayer declaring the dividends." (Former § 24402, subd. (a).)

In 2000, the Legislature amended subdivision (a) of section 24402 by replacing the phrase "income year" with "taxable year." For calendar and fiscal years beginning after January 1, 2000, "income year" and "taxable year" have the same meaning. (See Historical and Statutory Notes, 62 West's Ann. Rev. & Tax. Code (2003 supp.) foll. § 24402, p. 241.)

Subdivision (b) of section 24402 limits the deduction described in subdivision (a) in the following manner: (1) if the taxpayer owns more than 50 percent of the stock of the dividend-paying corporation, the taxpayer may deduct 100 percent of the dividends; (2) if the taxpayer owns 20 percent or more of the stock of the dividend-paying corporation, the taxpayer may deduct 80 percent of the dividends; (3) if the taxpayer owns less than 20 percent of the stock of the taxpaying corporation, the taxpayer may deduct 70 percent of the dividends. (§ 24402, subd. (b)(1)-(3) & (c).)

Even though this case involves a former version or versions of section 24402 in effect from 1992 to 1998, we refer to former section 24402 as section 24402, for ease of reference.

clause, we follow *Ceridian Corp. v. Franchise Tax Bd.* (2000) 85 Cal.App.4th 875 (*Ceridian*), in which the First District held that California Revenue and Taxation Code section 24410, which governs taxation of insurance company dividends paid to major corporate stockholders, was unconstitutional under the commerce clause.

The Franchise Tax Board (FTB) appeals from a judgment awarding plaintiff Farmer Bros. Co. (Taxpayer) state tax refunds totaling $811,000 for the tax years 1992 through 1998, plus interest and costs, as a remedy for overpaying taxes under the provisions of section 24402, which statute the trial court determined to be unconstitutional under the commerce clause. We agree with the trial court's conclusion and affirm the judgment.

FACTUAL AND PROCEDURAL BACKGROUND

This case was submitted for determination by the trial court on a joint stipulation of facts and written trial briefs, which provide the undisputed factual background.

Taxpayer is a California corporation primarily engaged in the business of manufacturing and selling coffee and coffee-related products. For the years 1992 through 1998, Taxpayer timely filed California corporate income or franchise tax returns with the FTB. Each return reported a "dividends received deduction" under section 24402, representing a portion of the dividends Taxpayer had received during the income year. Taxpayer owned less than 20 percent of the stock in each of the payer corporations which had issued dividends to Taxpayer during the years at issue. Thus, for those dividends which qualify for the deduction under the terms of section 24402, subdivision (a), the statute affords Taxpayer a maximum

deduction of 70 percent of the amount of the dividend. (§ 24402, subd. (b); see fn. 2, *ante.*)

FTB had promulgated a schedule listing the corporations and the percentage of their dividends that were deductible under section 24402. The schedule was based on a formula which allowed for a sliding scale deduction so that the taxpayer was entitled to more of a deduction if more of the income of the payer corporation was subject to specified California corporate taxes. (See Cal. Code Regs., tit. 18, § 24402 (rule 24402).)

As explained in rule 24402, "Taxpayers are permitted a deduction under Section 24402, for dividends received which were declared from income included in the measure of tax of the declaring corporation under this part." Rule 24402 also provides three examples to illustrate the operation of the dividends received deduction. Example (1) states: "The A Corporation receives dividends from B Corporation, whose entire income is also subject to tax under this part and has no other earnings not taxable under this part. A is allowed a deduction for all such dividends received from B." (Rule 24402.) Example (2) states: "The A Corporation received dividends from B Corporation, which is not subject to tax in California. None of the dividends received from B are deductible." (*Ibid.*) Example (3) states: "The A Corporation receives dividends from B Corporation, whose income is subject to allocation because its activities are carried on within and without the State. B's allocation percentage is 50 percent. The percentage of the dividends received by A which are deductible is determined by formula. The variance from 50 percent will be affected by the extent of nonunitary and nontaxable income." (*Ibid.*)

The concept of a "unitary business" has been developed in cases addressing the problem of the local taxation of businesses operating in more than one jurisdiction. (See *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 164-166, [103 S.Ct. 2933, 2939-2941, 77 L.Ed.2d 545].) "California, like many other States, uses what is called a 'unitary business' income-calculation system for determining its taxable share of a multistate corporation's business income. . . . [¶] The income of which California taxes a percentage is constitutionally limited to a corporation's 'unitary' income. Unitary income normally includes all income from a corporation's business activities, but excludes income that 'derive[s] from unrelated business activity which constitutes a discrete business enterprise,' [citation]. As we have said, this latter 'nonunitary' income normally is not taxable by any State except the corporation's State of domicile (and the States in which the 'discrete enterprise' carries out its business)." (*Hunt-Wesson, Inc. v. Franchise Tax Bd.* (2000) 528 U.S. 458, 460-461, [120 S.Ct. 1022, 1024-1025, 145 L.Ed.2d 974].)

Pursuant to FTB's formula and schedule for dividends deductible under section 24402, some of the dividends received by Taxpayer from certain corporations in certain years were not deductible. For example, in 1998 Taxpayer received a dividend from Farmland Industries of about $11,000, but no part of the dividend was deductible, based on section 24402 and Farmland Industries's paying no California franchise tax in 1998. As to other corporations which paid dividends to Taxpayer, various portions of those dividends were subject to the section 24402 deduction. For example, in 1998, Taxpayer received a total dividend of about $4,800 from Merrill Lynch but only

1.839 percent of that dividend, or about $89, was deductible. As to a total dividend in 1992 of $17,550 from San Diego Gas & Electric, almost all of the dividend, or 99.546 percent, was deductible.

Taxpayer timely filed amended tax returns claiming a dividends received deduction for all dividends received for the years at issue and requested refunds totaling over $800,000, plus interest. Taxpayer asserted as the ground for the refunds that section 24402 violated the commerce clause of the United States Constitution. FTB denied Taxpayer's claims for refunds. Taxpayer appealed the denial to the State Board of Equalization (Board), which considered the appeal and sustained FTB's action on the ground that the Board "does not have the authority to deny the application of Revenue and Taxation Code section 24402 on constitutional grounds."

In September 2000, Taxpayer filed the instant action for refund of corporate franchise or income tax. In a first amended complaint, Taxpayer asserted that section 24402 is unconstitutional under the commerce clause of the United States Constitution because it discriminates on its face against interstate commerce by improperly taxing income that is not attributable to business transacted in California and the deduction cannot be justified as a lawful compensatory tax. FTB answered the first amended complaint in May 2001.

On the trial date, October 25, 2001, the parties filed opening trial briefs and a joint stipulation of facts and lodged interrogatories propounded by Taxpayer and FTB's responses. A witness list proffered by FTB indicated it intended to call as witnesses Professors Richard Pomp and Stephen Sheffrin regarding the issue of whether section

24402 violated the commerce clause. In response to FTB's witness list, Taxpayer filed a motion in limine to bar expert testimony on the constitutionality issue. The October 25, 2001 minute order indicates that the parties agreed to bifurcate the trial, with the court adjudicating first the issue of the constitutionality of section 24402 and then, if necessary, the issue of remedy. The court afforded the parties until November 8, 2001, to file responses to the opening briefs. With respect to the motion in limine, the minute order states that FTB would have until November 8, 2001, to file opposition and then "the cause will stand submitted. [¶] If the plaintiff's motion in-limine to bar expert testimony on the constitutionality issue is denied and expert testimony is to be taken, trial will be continued into early next year for that testimony."

In FTB's response to the motion in limine, FTB faulted Taxpayer for failing to obtain any discovery with respect to expert witnesses and instead, "on the day set for trial, Taxpayer file[d] a motion in which it presents to the Court Taxpayer's assumptions as to the nature of the testimony to be offered by the Board's witnesses and asks that they be barred from testifying because this assumed testimony is inadmissible. Taxpayer is not only tilting at windmills, it is doing so after constructing the very edifices at which it aims its lance." FTB then pointed out that expert opinion testimony properly could be offered as to factual issues arising under the compensatory tax doctrine defense but expressly refused to go into any greater detail as to any such testimony, thus refusing "to give Taxpayer the benefits . . . which it would have received had it exercised the diligence necessary to elicit and refine such information [through discovery]." According to FTB, "Taxpayer's remaining option is to wait until questions are

posed to the Board's independent expert witnesses and then interpose such objections as it deems appropriate."

On November 8, 2001, both parties filed responsive trial briefs. FTB's brief addressed the issue of the compensatory tax doctrine, but FTB did not offer any testimony or additional evidence as to that issue.

On November 21, 2001, the court issued its ruling on submitted matter, ruling in pertinent part: "It is agreed that to the extent that a dividend-paying corporation had a larger share of its sales, property and/or payroll in California, plaintiff was entitled under [section 24402] to deduct a larger percentage of the dividends it received – up to a maximum deduction of 70 percent. On the other hand, the section permits no tax deduction as to dividends generated from business outside of California. . . . [¶ FTB] maintains that because in-state corporations have already been subjected to franchise tax, the statutory goal is merely compensatory. It argues: 'The purpose of (the statute) is to prevent the imposition of a second tax upon the stream of income leading to the dividend (citations). California's only responsibility is to prevent . . . double taxation. . . . ' In effect, defendant argues that both the statute's intent and effect are non-discriminatory.

"This court disagrees. . . . It is a scheme . . . that facially places an unconstitutional burden on interstate commerce.

"Plaintiff's objection to the proffer of live testimony by [defendant's] expert is denied as moot."

At a January 29, 2002 further status conference, which was not reported, the court ordered that the issue of remedy was to be determined after the parties submitted

briefs on the issue. FTB thereafter filed a petition for an extraordinary writ, challenging, among other rulings, the ruling denying plaintiff's motion in limine as moot. In its writ petition, FTB argued that if the Court of Appeal "concludes that factual questions remain to be answered before this issue [whether section 24402 is a permitted compensatory tax] can be resolved, then due process requires that [FTB] be allowed to present the testimony of its named expert witnesses for that purpose." On March 7, 2002, we denied the petition for extraordinary writ. (*Franchise Tax Board v. Superior Court* (Mar. 7, 2002, B156702).)

After the parties submitted briefs on the issue of the appropriate remedy, the court determined that Taxpayer was entitled to recover refunds of corporate income and franchise taxes for the years 1992 to 1998 totaling $811,000, plus interest and costs. The judgment awarded Taxpayer a remedy consisting of the deduction set out in section 24402 for dividends received, as if the dividends were "declared from income which [had] been included in the measure of the taxes imposed . . . upon the taxpayer declaring the dividends." (§ 24402, subd. (a).) Judgment was entered on May 13, 2002. FTB filed a timely notice of appeal from the judgment.

FTB challenges only the finding that section 24402 is unconstitutional under the commerce clause, and not the finding that a tax refund is the proper remedy for the invalidity of section 24402. FTB does not challenge the remedy, and the parties do not discuss that issue, so neither do we. In other words, if we agree with the trial court's finding of unconstitutionality, then we may affirm the judgment without addressing the issue of remedy.

DISCUSSION

As the issue of the constitutionality of section 24402 under the commerce clause is presented on undisputed facts and is one of law, our review is de novo. (*Ghirardo v. Antonioli* (1994) 8 Cal.4th 791, 799-801; *State of Ohio v. Barron* (1997) 52 Cal.App.4th 62, 67 [constitutional issues are reviewed de novo].)

A. Section 24402 is Facially Discriminatory

"The Constitution gives Congress the power to regulate commerce between the states. (U.S. Const., art. I, § 8, cl. 3.) 'Though phrased as a grant of regulatory power to Congress, the [Commerce] Clause has long been understood to have a "negative" aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce. [Citations.]' [Citation.]" (*Ceridian, supra,* 85 Cal.App.4th at p. 882.) This negative aspect of the commerce clause, also known as the dormant commerce clause (*Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, 331, [116 S.Ct. 848, 854, 133 L.Ed.2d 796] (*Fulton*)), prohibits economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors. (*Ceridian, supra,* 85 Cal.App.4th at p. 882.)

In evaluating state regulatory measures under the dormant commerce clause, the United States Supreme Court has held that the first step is to determine whether it regulates evenhandedly with only incidental effects on interstate commerce or discriminates against interstate commerce. (*Fulton, supra,* 516 U.S. at p. 331 [North Carolina's intangibles tax violated the dormant commerce clause].) With respect to state taxation, a state law is

treated as discriminatory if it taxes a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the state. (*Ibid.; Ceridian, supra,* 85 Cal.App.4th at p. 882.) "State laws discriminating against interstate commerce on their face are 'virtually *per se* invalid.'" (*Fulton, supra,* 516 U.S. at p. 331.) A law that is discriminatory on its face must be invalidated unless the state can show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. (*Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.* (1994) 511 U.S. 93, 100-101 [114 S.Ct. 1345, 1351, 128 L.Ed.2d 13] (*Oregon Waste*) [Oregon's $2.25 per ton surcharge on disposal of out-of-state waste violated commerce clause in view of $0.85 per ton charge imposed on solid in-state waste].)

"[A] tax may violate the commerce clause even if it has no discriminatory goal or intent, if it is facially discriminatory, or has the *effect* of unduly burdening interstate commerce. [Citations.] 'Absent a compelling justification . . . a State may not advance its legitimate goals by means that facially discriminate against [interstate] commerce.'" (*Ceridian, supra,* 85 Cal.App.4th at p. 884.) "Our cases require that justifications for discriminatory restrictions on commerce pass the 'strictest scrutiny.' [Citation.] The State's burden of justification is so heavy that 'facial discrimination by itself may be a fatal defect.'" (*Oregon Waste, supra,* 511 U.S. at p. 101.)

We conclude that section 24402 is discriminatory on its face because it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California.

As a result, the dividends received deduction scheme favors dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations which do not do business in California and pay no taxes in California. The deduction thus discriminates between transactions on the basis of an interstate element, which is facially discriminatory under the commerce clause. (*Armco Inc. v. Hardesty* (1984) 467 U.S. 638, 642 [104 S.Ct. 2620, 2622, 81 L.Ed.2d 540].) "That the tax discrimination comes in the form of a deprivation of a generally available tax benefit, rather than a specific penalty on the activity itself, is of no moment" under commerce clause jurisprudence. (*Camps Newfound/ Owatonna, Inc. v. Town of Harrison* (1997) 520 U.S. 564, 578-579 [117 S.Ct. 1590, 1599, 137 L.Ed.2d 852].)

"A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among [in-state] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." (*Fulton, supra,* 516 U.S. at p. 333.) In *Fulton,* the court held invalid under the commerce clause North Carolina's "intangibles tax," which taxed "a fraction of the value of corporate stock owned by North Carolina residents inversely proportional to the corporation's exposure to the State's income tax." (*Id.* at p. 327.)

Like the sliding scale deduction at issue in this case, residents of North Carolina were "entitled to calculate their tax liability by taking a taxable percentage deduction equal to the fraction of the issuing corporation's income subject to tax in North Carolina." (*Fulton, supra,* 516 U.S. at p. 328.) "Thus, a corporation doing all of its business

within the State would pay corporate income tax on 100% of its income, and the taxable percentage deduction allowed to resident owners of that corporation's stock under the intangibles tax would likewise be 100%. Stock in a corporation doing no business in North Carolina, on the other hand, would be taxable on 100% of its value. For the intermediate cases, holders of stock were able to look up the taxable percentage for a large number of corporations as determined and published annually by the North Carolina Secretary of Revenue. . . . " (*Ibid.*) The *Fulton* court concluded that "[t]here is no doubt that the intangibles tax facially discriminates against interstate commerce," because such a tax "favors domestic corporations over their foreign competitors in raising capital," and tends "to discourage domestic corporations from plying their trades in interstate commerce." (*Id.* at p. 333.)

Ceridian applied the principles in *Fulton* to Revenue and Taxation Code section 24410, which "allows a deduction in computing taxable income ([Rev. & Tax. Code,] § 24401) for 'Dividends received by a corporation commercially domiciled in California . . . from an insurance company subject to tax imposed by [the "Insurance Taxation" part] of this division at the time of the payment of the dividends and at least 80 percent of each class of its stock then being owned by the corporation receiving the dividend.'" (*Ceridian, supra,* 85 Cal.App.4th at p. 881.) The *Ceridian* court concluded that "a statutory scheme, such as the one before us, that disallows a deduction based on the amount of *property and employees* that the dividend-declaring insurer has in another state, favors domestic corporations over their foreign competitors in raising capital among California corporations, and tends, at least, to discourage domestic corporations from plying their

trade in interstate commerce, from purchasing property or hiring employees in other states, and from purchasing subsidiary insurance corporations that do so. Thus, [Revenue and Taxation Code] section 24410, subdivision (b) is unquestionably discriminatory on its face." (*Ceridian, supra,* 85 Cal.App.4th at p. 887.)

"Just as North Carolina [in *Fulton, supra,* 516 U.S. 325,] reduced its intangibles tax in direct proportion to the amount of business the owned corporation did within the state's borders, so too California reduces the dividend tax to the extent such dividends are 'paid from income from California sources,' ([Rev. & Tax. Code,] § 24410, subd. (b)), which is calculated based on the proportionate amount of property, payroll and gross receipts the owned corporation has within California. *Fulton* prohibits such discriminatory treatment." (*Ceridian, supra,* 85 Cal.App.4th at p. 887.)

Because the dividends received deduction of section 24402 discriminates against corporations engaged in interstate commerce in the same fashion as does Revenue and Taxation Code section 24410, *Ceridian* provides persuasive authority to support our conclusion that section 24402 is discriminatory on its face. While FTB correctly points out that *Ceridian* did not address the same statute involved here, and that we are not bound by that opinion, FTB still offers no cogent reason why *Ceridian's* analysis is not convincing in resolving the commerce clause issue in this case.

We also reject FTB's claim that section 24402 does not violate the "internal consistency doctrine" in assessing whether a tax is discriminatory. "The internal consistency doctrine requires that the imposition of a tax identical to a

challenged tax in every state would add no burden to interstate commerce that intrastate commerce did not also bear, and looks at the structure of the challenged tax to see whether its identical application by every state would place interstate commerce at a disadvantage against intrastate commerce." (*D.D.I., Inc. v. State* (2003) 657 N.W.2d 228, 234 (*D.D.I.*) [similar dividends received deduction held unconstitutional under commerce clause and was not a valid compensatory tax].) Here, the imposition of the dividends received deduction by every state would favor intrastate commerce over interstate commerce by giving a greater tax benefit to taxpayers investing in their home state corporations as opposed to out-of-state corporations or corporations engaged in multistate business. Section 24402 violates the internal consistency doctrine.

B. FTB Fails to Justify Section 24402 as a Compensatory Tax

"[A] facially discriminatory tax may still survive Commerce Clause scrutiny if it is a truly '"compensatory tax" designed simply to make interstate commerce bear a burden already borne by intrastate commerce.'" (*Fulton, supra,* 516 U.S. at p. 331.) "Though our cases sometimes discuss the concept of the compensatory tax as if it were a doctrine unto itself, it is merely a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means. . . . Under that doctrine, a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the negative

Commerce Clause." (*Oregon Waste, supra,* 511 U.S. at p. 102.)

The cases have distilled three conditions, or prongs, necessary for a valid compensatory tax: (1) A state must, as a threshold matter, identify the intrastate tax burden for which the state is attempting to compensate, (2) the tax on interstate commerce must be shown roughly to approximate, but not exceed, the amount of the tax on intrastate commerce, and (3) the events on which the interstate and intrastate taxes are imposed must be substantially equivalent, that is, they must be sufficiently similar in substance to serve as mutually exclusive proxies for each other. (*Fulton, supra,* 516 U.S. at pp. 332-333.)

Addressing the first prong, as explained in *Oregon Waste,* "The prototypical example of substantially equivalent taxable events is the sale and use of articles of trade. [Citation.] In fact, use taxes on products purchased out of state are the only taxes we have upheld in recent memory under the compensatory tax doctrine." (*Oregon Waste, supra,* 511 U.S. at p. 105.)

FTB argues that "[t]he intrastate burden that section 24402 compensates for is the California tax burden on the income of the dividend payor, when that income is again included in the income of the corporate dividend recipient." Yet the United States Supreme Court in *Fulton,* citing *Oregon Waste,* warned "of the danger of treating general revenue measures as relevant intrastate burdens for purposes of the compensatory tax doctrine. '[P]ermitting discriminatory taxes on interstate commerce to compensate for charges purportedly included in general forms of intrastate taxation would allow a state to tax interstate commerce more heavily than in-state commerce

anytime the entities involved in interstate commerce happened to use facilities supported by general state tax funds.' [Citation.] We declined then [in *Oregon Waste*], as we do now, 'to open such an expansive loophole in our carefully confined compensatory tax jurisprudence.'" (*Fulton, supra,* 516 U.S. at p. 335.)

A "double taxation" argument similar to that made by FTB was rejected by the Supreme Court of North Dakota in *D.D.I., supra,* 657 N.W.2d 228, which involved a similar dividends received deduction. "Although avoiding double taxation of North Dakota income is a permissible goal, the Commissioner has not identified any specific in-state activity or benefit received by the taxpayers to justify the compensatory levy on their dividends received from out-of-state corporations. The State of North Dakota does not have a general sovereign interest in taxing income earned out-of-state and must identify some specific in-state activity or benefit to justify a compensatory levy. [Citation.] The Commissioner has failed to establish such an in-state benefit to the taxpayers." (*Id.* at p. 234.)

As pointed out by the court in *D.D.I.,* the double taxation argument also ignores the corporate income tax that an out-of-state corporation's state might impose. Thus, the dividends received deduction "does not avoid double taxation for out-of-state corporate income and does not roughly approximate the tax on intrastate commerce. . . ." (*D.D.I., supra,* 657 N.W.2d at p. 234.)

Based on the same reasoning set out in *Fulton* and *D.D.I.,* we conclude that FTB has failed to establish the first prong of the compensatory tax doctrine.

The second prong of the compensatory tax is that it must roughly approximate the amount of the tax on

intrastate commerce. The Supreme Court in *Oregon Waste* acknowledged the difficulty of satisfying this element when the state contends that the tax burden on interstate commerce compensates for the burden of state income taxes. Whether or not the interstate tax burden roughly approximates the intrastate tax burden "is difficult to determine, as '[general] tax payments are received for the general purposes of the [government], and are, upon proper receipt, lost in the general revenues.'" (*Oregon Waste, supra,* 511 U.S. at p. 104.)

In *Fulton,* the court discussed the theory that one of the services provided by the state of North Carolina, and supported through its general corporate income tax, is the maintenance of a capital market for corporations wishing to sell stock to state residents. The Secretary of Revenue of North Carolina argued that the state "may require those companies to pay for the privilege of access to the State's capital markets by a tax on the value of the shares sold." (*Fulton, supra,* 516 U.S. at p. 335.) The *Fulton* court found the argument unconvincing. "North Carolina, like most States, regulates access to its capital markets by means of blue sky laws, [citation], and their accompanying regulations, which prescribe who may sell securities in North Carolina, the procedures that must be followed to do so, and the fees imposed for the privilege. [Citations.] Absent probative evidence to the contrary, which the [State] has not supplied, we can reasonably assume that North Carolina has provided for the upkeep of its capital market through these provisions, not through the general corporate income tax. [¶] If the corporate income tax does not support the maintenance of North Carolina's capital market, then the State has not justified imposition of a

compensating levy on the ownership of shares in corporations not subject to the income tax." (*Id.* at p. 336, fn. omitted.)

As explained in *Fulton,* the corporate income tax "is a general form of taxation, not assessed according to the taxpayer's use of particular services, and before its revenues are earmarked for particular purposes they have been commingled with funds from other sources. As a result, the [State] cannot tell us what proportion of the corporate income tax goes to support the capital market, or whether that proportion represents a burden greater than the one imposed on interstate commerce by the intangibles tax. . . . [¶] . . . Where general forms of taxation are involved, we ordinarily cannot even begin to make the sorts of qualitative assessments that the compensatory tax doctrine requires." (*Fulton, supra,* 516 U.S. at p. 338.)

The court in *Fulton* acknowledged that "[w]hile we need not hold that a State may never justify a compensatory tax by an intrastate burden included in a general form of taxation, the linkage in this case between the intrastate burden and the benefit shared by out-of-staters is far too tenuous to overcome the risk posed by recognizing a general levy as a complementary twin." (*Fulton, supra,* 516 U.S. at p. 336.) Thus, while it may not have been "inconceivable, however unlikely, that a capital markets component of the corporate income tax exceeds the intangibles tax in magnitude," the court in *Fulton* concluded that the state had not met its burden of demonstrating the second prong of the compensatory tax doctrine. (*Id.* at p. 338.)

As in *Fulton,* FTB also has not met its burden of demonstrating the second prong of the compensatory tax doctrine.

The third prong of the compensatory tax doctrine requires that the compensating taxes fall on substantially equivalent events. FTB argues that this condition is met because corporate income and the dividend paid from that income are the "same dollars" and are substantially similar events. Yet, *Fulton* expressly disapproved of this analysis with respect to the intangibles tax. "[W]e find that the intangibles tax is not functionally equivalent to the corporate income tax." (*Fulton, supra,* 516 U.S. at p. 339.) Because the objective of the equivalent-event requirement is to enable in-state and out-of-state businesses to compete on an equal footing, "[t]his equality of treatment does not appear when the allegedly compensating taxes fall respectively on taxpayers who are differently described, as, for example, resident shareholders and corporations doing business out of state. A State defending such a tax scheme as one of complementary taxation, therefore, has the burden of showing that the actual incidences of the two tax burdens are different enough from their nominal incidences so that the real taxpayers are within the same class, and that therefore a finding of combined neutrality on interstate competition would at least be possible." (*Id.* at p. 340.)

The court in *Fulton* noted that determining whether the tax burden is shifted out of state, rather than borne by in-state producers and consumers, requires complex factual inquiries, and that courts as institutions are poorly equipped to evaluate with precision the relative burdens of various methods of taxation. (*Fulton, supra,* 516 U.S. at pp. 341-342.) "Indeed, the general difficulty of comparing

the economic incidence of state taxes paid by different taxpayers upon different transactions goes a long way toward explaining why we have so seldom recognized a valid compensatory tax outside the context of sales and use taxes." (*Id.* at p. 342.)

Thus, under the third prong of the compensatory tax doctrine, FTB must establish that the burden created by the structure of the dividends received deduction falls on the same class of taxpayers as does the corporate income tax. Yet the burden of section 24402 is on the taxpayer receiving dividends, while the burden of the corporate income tax is on the payer corporation. FTB has failed to offer any factual or logical support for its claim that the actual incidences of these two taxes are imposed upon the same class of taxpayers (see *Fulton, supra,* 516 U.S. at p. 340, fn. 6) or that the dividends received deduction amounts to a clear equivalent for the corporate income tax. As stated by the court in *Fulton,* "there are reasons to doubt the [State's] contention that the corporate income tax amounts to a clear equivalent for the burden on shareholding imposed by the intangibles tax." (*Id.* at p. 344.) Because the doubts expressed in *Fulton* also arise here, we conclude that FTB fails to establish the third prong of the compensatory tax doctrine.

As FTB fails to justify section 24402 as a compensatory tax, and it impermissibly discriminates against interstate commerce, the statute violates the commerce clause.

C. Expert Witness Testimony

FTB contends that the trial court erroneously denied it the opportunity to present expert testimony relating to

the compensatory tax doctrine. FTB fails to show that it ever proffered or sought to introduce any such testimony, that it made an offer of proof, or that the trial court made any ruling on the matter. In other words, there is simply no ruling for us to review. A party on appeal cannot successfully complain because the trial court failed to do something which it was not asked to do. (*Chyten v. Lawrence & Howell Investments* (1994) 23 Cal.App.4th 607, 617.)

DISPOSITION

The judgment is affirmed.

CERTIFIED FOR PUBLICATION.

MALLANO, J.

We concur:

ORTEGA, Acting P.J.

VOGEL (MIRIAM A.), J.

APPENDIX B

Robin C. Campbell (#070374)
ANGLIN, FLEWELLING, RASMUSSEN,
CAMPBELL & TRYTTEN LLP
199 South Los Robles Avenue, Suite 600
Pasadena, California 91101
Telephone: (626) 535-1900
Facsimile: (626) 577-7764

Thomas H. Steele (#72799)
Amy L. Silverstein (#154221)
MORRISON & FOERSTER LLP
425 Market Street
San Francisco, California 94105-2482
Telephone: (415) 268-7000
Facsimile: (415) 268-7522

Attorneys for Plaintiff
FARMER BROS. CO.

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF LOS ANGELES

FARMER BROS. CO., a California corporation, Plaintiff, vs. FRANCHISE TAX BOARD, Defendant.	Case No.: BC237663 [~~AMENDED PROPOSED~~] JUDGMENT Judge: Hon. Gregory O'Brien (Filed May 13, 2002)

This action came on regularly for trial on October 25, 2001 and subsequent dates in Department 21 of the above-entitled Court, the Honorable Gregory O'Brien, presiding. Robin C. Campbell of Anglin, Flewelling, Rasmussen, Campbell & Trytten LLP appeared as the attorneys for

plaintiff Farmer Bros. Co., and Herbert A. Levin and Gregory Price, Deputy Attorneys General of the State of California, appeared as attorneys for defendant Franchise Tax Board.

The Court heard and considered evidence, including the stipulation of facts and supplemental stipulation of facts submitted by the parties, and the written arguments of counsel. The matter having been submitted for decision,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED:

1. That plaintiff Farmer Bros. Co. recover from defendant Franchise Tax Board a money judgment for $811,000.00, consisting of refunds of corporate income and franchise taxes for the following years in the following amounts:

a. $79,000 for income year 1992;
b. $79,000 for income year 1993;
c. $77,000 for income year 1994;
d. $137,000 for income year 1995;
e. $144,000 for income year 1996;
f. $150,000 for income year 1997; and
g. $145,000 for income year 1998.

2. That plaintiff Farmer Bros. Co. recover $563,738 in interest through April 30, 2002, plus additional interest thereafter as provided under Revenue and Taxation Code section 19391.

3. That plaintiff Farmer Bros. Co. recover its costs of litigation, as provided under Revenue and Taxation Code section 19717, consisting of $___ in reasonable court costs, $___ in reasonable expenses of expert witnesses, and $___ in reasonable attorneys' fees.

Dated: May 13, 2002

GREGORY G. O'BRIEN
Hon. Gregory O'Brien
Judge of the Superior Court

APPENDIX C

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION ONE

FRANCHISE TAX BOARD, Petitioner, v. THE SUPERIOR COURT OF LOS ANGELES COUNTY, Respondent; FARMER BROS., CO., Real Party in Interest.	B156702 (L.A.S.C. No. BC237663) (GREGORY O'BRIEN, Judge) ORDER (Filed Mar. 7, 2002)

THE COURT*:

The petition for writ of mandate/prohibition, filed February 26, 2002; and the preliminary opposition thereto, filed March 4, 2002, have been read and considered.

The petition is denied.

---

* ORTEGA, Acting P.J.

VOGEL (MIRIAM A.), J.

MALLANO, J.

APPENDIX D

Court of Appeal, Second Appellate District, Division One – No. B160061

S117131

IN THE SUPREME COURT OF CALIFORNIA

En Banc

FARMERS BROTHERS COMPANY,
Plaintiff and Respondent,

v.

FRANCHISE TAX BOARD, Defendant and Appellant.

(Filed Aug. 27, 2003)

Request for judicial notice GRANTED.
Petition for review DENIED.

Werdegar, J., was absent and did not participate.

/s/ George
Chief Justice

APPENDIX E

SUPERIOR COURT OF CALIFORNIA, COUNTY OF LOS ANGELES

DATE: 11/21/01 HONORABLE Gregory O'Brien HONORABLE 10 NONE	JUDGE JUDGE PRO TEM Deputy Sheriff
S. SMYTHE NONE	**DEPT. 21** DEPUTY CLERK ELECTRONIC RECORDING MONITOR Reporter
BC237663 FARMER BROS CO VS. FRANCHISE TAX BOARD	Plaintiff Counsel [NO APPEARANCES] Defendant Counsel

NATURE OF PROCEEDINGS:

RULING ON SUBMITTED MATTER

The matter before the court was submitted on briefs, including a joint stipulation as to the facts.

Plaintiff California coffee manufacturer is a shareholder of various companies engaged in interstate commerce. Plaintiff seeks a partial refund of taxes collected for the income years 1992 through 1998. The disputed taxes were levied upon certain of plaintiff's shareholder dividends declared by these companies.

It is agreed that to the extent that a dividend-paying corporation had a larger share of its sales, property and/or payroll in California, plaintiff was entitled under Revenue

& Tax Code Section 24402 to deduct a larger percentage of the dividends it received – up to a maximum deduction of 70 percent. On the other hand, the section permits no tax deduction as to dividends generated from business outside of California. Plaintiff challenges the constitutionality of Section 24402 on the basis that it imposes an impermissible burden on interstate commerce. Plaintiff urges that the court follow the reasoning of, among other cases, CERIDIAN CORPORATION v. FRANCHISE TAX BOARD (2000) 85 Cal.App.4th 875, which recently struck down similar provisions of Revenue & Tax Code Section 24410 on constitutional grounds. Plaintiff has exhausted its administrative remedies.

Defendant tax board maintains that because in-state corporations have already been subjected to franchise tax, the statutory goal is merely compensatory. It argues: "The purpose of (the statute) is to prevent the imposition of a second tax upon the stream of income leading to the dividend (citations). California's only responsibility is to prevent . . . double taxation. . . ." In effect, defendant argues that both the statute's intent and effect are non-discriminatory.

This court disagrees. Shareholders are the owners of a business. Dividends are declared earnings remitted to owners on a per-share basis. A tax on dividends properly is a tax upon an owner's income, not a tax on the "stream of income leading to the dividend." Therefore, what is really being "compensated" is the state's initial inability to impose a franchise tax on foreign corporations. By the device of giving harsher tax treatment to dividends from out-of-state businesses, California has managed to accomplish by indirection what it cannot do by direction, namely, it effectively has levied an in-lieu tax based upon corporate

income streams occurring beyond its borders. By subjecting shareholders of foreign corporations to different treatment, the State says, in effect, "since we can't impose a franchise tax on your business at the front end, we'll tax you personally in an equivalent sum at the back end." It is a scheme too clever by half, and one that facially places [an] unconstitutional burden on interstate commerce.

Defendant's objection to the proffer of live testimony by plaintiff's expert is denied as moot.

Plaintiff shall prepare a judgment consistent with this ruling.

Copies of this minute order are sent to the following counsel via U.S. Mail, addressed as follows:

Walker, Wright, Tyler & Ward
Attn.: Robin C. Campbell, Esq.
626 Wilshire Blvd., #900
Los Angeles, Calif. 90017-3209

Herbert A. Levin, Esq.
Dep. Atty. Gen.
300 S. Spring St., #5212
Los Angeles, Calif. 90013-1204

APPENDIX F

CALIFORNIA CODES
REVENUE AND TAXATION CODE
SECTION 24271

24271. (a) Section 61 of the Internal Revenue Code, relating to gross income defined, shall apply, except as otherwise provided.

(b) A distributive share of partnership gross income shall be determined in accordance with Part 10 (commencing with Section 17001).

(c) Income from an interest in an estate or trust shall be determined in accordance with Part 10 (commencing with Section 17001).

24401. In addition to the deductions provided in Article 1 (commencing with Section 24341), there shall be allowed as deductions in computing taxable income the items specified in this article.

24402. (a) A portion of the dividends received during the taxable year declared from income which as been included in the measure of the taxes imposed under Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), or Chapter 3 (commencing with Section 23501) upon the taxpayer declaring the dividends.

(b) The portion of the dividends which may be deducted under this section shall be as follows:

(1) In the case of any dividend described in subdivision (a), received from a "more than 50 percent owned corporation," 100 percent.

(2) In the case of any dividend described in subdivision (a), received from a "20 percent owned corporation," 80 percent.

(3) In the case of any dividend described in subdivision (a), received from a corporation that is less than 20 percent owned, 70 percent.

(c) For purposes of this section:

(1) The term "more than 50 percent owned corporation" means any corporation if more than 50 percent of the stock of that corporation (by vote and value) is owned by the taxpayer. For purposes of the preceding sentence, stock described in Section 1504(a) (4) of the Internal Revenue Code shall not be taken into account.

(2) The term "20 percent owned corporation" means any corporation if 20 percent or more of the stock of that corporation (by vote and value) is owned by the taxpayer. For purposes of the preceding sentence, stock described in Section 1504(a) (4) of the Internal Revenue Code shall not be taken into account.

(d)(1) No deduction shall be allowed under this section in respect of any dividend on any share of stock:

(A) which is held by the taxpayer for 45 days or less during the 90-day period beginning on the date which is 45 days before the date on which the share becomes ex-dividend with respect to that dividend, or

(B) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(2) In the case of stock having preference in dividends, if the taxpayer receives dividends with respect to that stock which are attributable to a period or periods aggregating in excess of 366 days, subparagraph (A) of paragraph (1) shall be applied as follows:

(A) By substituting "90 days" for "45 days" in each place it appears.

(B) By substituting "180-day period" for "90-day period."

(3) For purposes of this subdivision, in determining the period for which the taxpayer has held any share of stock:

(A) the day of disposition, but not the day of acquisition, shall be taken into account, and

(B) Section 1223(4) of the Internal Revenue Code shall not apply.

(4) Section 246(c) (4) of the Internal Revenue Code, relating to the holding period reduced for periods where risk of loss diminished, shall apply, except as otherwise provided.

(e)(1) The amendments made by the act adding this subdivision shall apply to dividends received or accrued after the 30th day after the date of the enactment of the act adding this subdivision.

(2) The amendments made by the act adding this subdivision shall not apply to dividends received or accrued during the two-year period beginning on the date of the enactment of the act adding this subdivision if:

(A) the dividend is paid with respect to stock held by the taxpayer on January 1, 1998 and all times thereafter until the dividend is received,

(B) that stock is continuously subject to a position described in Section 246(c) (4) of the Internal Revenue Code on January 1, 1998, and all times thereafter until the dividend is received, and

(C) that stock and position are clearly identified in the taxpayer's records within 30 days after the date of the enactment of the act adding this subdivision.

(3) Stock shall not be treated as meeting the requirement of subparagraph (B) of paragraph (2) if the position is sold, closed, or otherwise terminated and reestablished.

(3)

No. 03-776

Supreme Court, U.S.
FILED
DEC 23 2003
OFFICE OF THE CLERK

In The Supreme Court of the United States

FRANCHISE TAX BOARD,

Petitioner,

v.

FARMER BROS. CO.,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The Second Appellate District

OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

THOMAS H. STEELE
(Counsel of Record)
ANDRES VALLEJO
MORRISON & FOERSTER LLP
425 Market Street
San Francisco, CA 94105
(415) 268-7000 Fax: (415) 268-7522

ROBIN C. CAMPBELL
ANGLIN, FLEWELLING, RASMUSSEN,
CAMPBELL & TRYTTEN LLP
199 South Los Robles Avenue, Suite 600
Pasadena, CA 91101
(626) 535-1900 Fax: (626) 577-7764

Attorneys for Respondent Farmer Bros. Co.

COCKLE LAW BRIEF PRINTING CO. (800) 225-6964
OR CALL COLLECT (402) 342-2831

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, Farmer Bros. Co. states that it is a publicly held California corporation. Farmer Bros. Co. does not have a parent corporation and there are no publicly held companies owning 10% or more of Farmer Bros. Co.'s stock.

TABLE OF CONTENTS

	Page
CORPORATE DISCLOSURE STATEMENT	i
TABLE OF AUTHORITIES	iii
PRELIMINARY MATTERS	1
STATEMENT OF THE CASE	1
REASONS FOR DENYING THE PETITION	2
A. There Is No Conflict in Judicial Authority over the Proper Resolution of the Question Presented	3
B. The Decision Below Is Compelled by This Court's Decision in *Fulton*	6
THE QUESTIONS POSED BY THE STATE WOULD NEITHER PROVIDE IMPORTANT GUIDANCE NOR CONTROL THE RESULT IN THIS CASE	9
CONCLUSION	11
APPENDIX A: *D.D.I., Inc. v. State*, 2003 N.D. 32, 657 N.W.2d 228 (2003)	App. 1
APPENDIX B: *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal. App. 4th 875 (2000)	App. 15

TABLE OF AUTHORITIES

Page

CASES

Am. Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987) 4

Armco Inc. v. Hardesty, 467 U.S. 638 (1984) 4

Ceridian Corp. v. Franchise Tax Bd., 85 Cal. App. 4th 875 (2000) 5, 6

D.D.I., Inc. v. State, 2003 N.D. 32, 657 N.W.2d 228 (2003) 3, 4, 5

Fulton Corp. v. Faulkner, 516 U.S. 325 (1996) ..... *passim*

Oregon Waste Sys., Inc. v. Dep't of Envtl. Quality of Or., 511 U.S. 93 (1994) 3

Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232 (1987) 4

CONSTITUTIONAL AND STATUTORY PROVISIONS

Cal. Rev. & Tax. Code § 24402 1

PRELIMINARY MATTERS

Respondent, Farmer Bros. Co. ("Farmer Bros."), accepts the description of Parties to the Proceeding, the Opinions Below, the Basis for Supreme Court Jurisdiction, and the Constitutional and Statutory Provisions Involved as stated by Petitioner, Franchise Tax Board ("FTB"), in its Petition for a Writ of Certiorari ("Petition").

Farmer Bros. supplements the FTB's Statement of the Case in the following section. Farmer Bros. clarifies the Question Presented for Review in its discussion of the Reasons for Denying the Petition, set forth below.

STATEMENT OF THE CASE

Two material features of the ruling by the California Court of Appeal below were neglected by the FTB in its summary.

First, in addition to finding that section 24402 of the California Revenue and Taxation Code facially discriminates against interstate commerce, the Court of Appeal concluded the statute also violates the "internal consistency doctrine" because the adoption of an identical statute by other states would impose a burden of multiple taxation where dividend-paying companies and dividend-receiving companies are located in different states. No such multiple tax burden would be imposed where those companies are located within a single state. (Ct. App. Op., Pet. App. 14-15.)[1]

[1] References to the Appendix to the Petition for a Writ of Certiorari are denominated "Pet. App." followed by a page reference. References to

(Continued on following page)

Second, the Court of Appeal rejected the FTB's claim that the trial court had erroneously excluded expert testimony to support the FTB's position that the compensatory tax defense should save the dividends received deduction from invalidation under the Commerce Clause. The Court of Appeal concluded, "FTB fails to show that it ever proffered or sought to introduce any such testimony, that it made an offer of proof, or that the trial court made any ruling on the matter. In other words, there is simply no ruling for us to review. A party on appeal cannot successfully complain because the trial court failed to do something which it was not asked to do." (*Id.* at 22.)

REASONS FOR DENYING THE PETITION

This case involves the question of whether a state that grants a dividends received deduction ("DRD") can permissibly limit that deduction to dividends paid from income previously taxed by that state. Every court that has considered this question has concluded that such a limited DRD violates the Commerce Clause. The unanimity of judicial authority on this question is not surprising, because it is compelled by this Court's unanimous opinion in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), which struck down a tax regime that was functionally identical to these limited DRDs. For these reasons and for others discussed below, the Petition should be denied.

---

the Petition for a Writ of Certiorari are denominated "Pet." followed by a page reference.

A. There Is No Conflict in Judicial Authority over the Proper Resolution of the Question Presented

Two other state courts have considered the constitutionality of limited DRDs that were in all essential respects identical to the limited DRD at issue here, and each court struck down the DRD for the same reasons on which the decision below relied.

D.D.I., Inc. v. State

In *D.D.I., Inc. v. State*, 2003 N.D. 32, 657 N.W.2d 228 (2003), the North Dakota Supreme Court considered a DRD that was in all practical respects identical to the DRD here. In that case, the State Tax Commissioner conceded that the limited DRD "facially discriminate[d] against interstate commerce," *id.* at ¶ 7, 657 N.W.2d at 231, but, like the FTB in this case, the Tax Commissioner argued that the restricted DRD was saved by the compensatory tax defense and should not be treated as discriminatory because its purpose was to prevent double taxation.

The North Dakota Supreme Court rejected that argument, finding that the Tax Commissioner had failed to meet at least two of the three prongs required to establish the compensatory tax defense.[2] First, like the lower court here, the North Dakota Supreme Court found that the State had failed to identify "any specific in-state activity or benefit received by the taxpayers to justify the

[2] To invoke successfully the compensatory tax defense, a state must meet all three prongs of the defense. *See, e.g., Fulton Corp. v. Faulkner*, 516 U.S. 325, 332, 344 (1996); *Oregon Waste Sys., Inc. v. Dep't of Envtl. Quality of Or.*, 511 U.S. 93, 103 (1994).

compensatory levy on their dividends received from out-of-state corporations." *Id.* at ¶ 15, 657 N.W.2d at 234. In doing so, the North Dakota Supreme Court, like the Court of Appeal in this case, rejected the State's attempt to rely upon the income tax imposed upon in-state operating companies as a compensatory twin for the income tax imposed upon companies receiving dividends.[3]

Second, the North Dakota Supreme Court found that when the effects of other state taxes on the dividend-paying company were considered, the State's limited DRD did not result in a tax on interstate commerce that roughly approximates the tax on intrastate commerce. Here the North Dakota court's analysis essentially mirrors the California court's analysis in this case and rests upon the framework developed in this Court's internal consistency cases. *See, e.g., Armco Inc. v. Hardesty*, 467 U.S. 638 (1984); *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987); *Am. Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266 (1987).

Third, because the Tax Commissioner had failed to meet the first two prongs of the compensatory tax defense, the North Dakota Supreme Court concluded it need not address whether the limited DRD satisfied the third prong of the compensatory tax defense, *i.e.*, whether the taxes on intrastate and interstate commerce were imposed upon substantially equivalent events.

---

[3] Farmer Bros. concurs with the FTB that under this Court's precedent, the denial of a deduction should be treated as equivalent to the imposition of a tax. (Pet. 14 n.16.)

Finally, in regard to whether the purpose of preventing double taxation ought to save the limited DRD, the North Dakota Supreme Court stated:

> [A]lthough avoiding double taxation of North Dakota income is a legitimate legislative goal, "the purpose of, or justification for, a law has no bearing on whether it is facially discriminatory." *Oregon Waste*, at 100. We have concluded the method employed by the State of North Dakota impermissibly discriminates against interstate commerce. Taxpayers have asserted and the Commissioner does not dispute there are nondiscriminatory means to accomplish the goal of avoiding double taxation on North Dakota corporate income.

D.D.I., at ¶ 19, 657 N.W.2d at 235.

Ceridian Corp. v. Franchise Tax Bd.

Another district of the same California Court of Appeal that issued the opinion in this case issued an earlier decision involving a limited DRD that was applicable to dividends paid by insurance companies. *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal. App. 4th 875 (2000). Like the limited DRD in this case, this insurance DRD was also restricted to dividends paid from insurance income "from California sources." Apparently for that reason, in *Ceridian* the FTB had characterized the insurance DRD at issue as the "counterpart" to the more general DRD at issue in this case. *Id.* at 884.

In *Ceridian,* as here, the FTB argued that the insurance DRD did not constitute facial discrimination against interstate commerce because its purpose was to avoid double taxation of California income. Nonetheless, as in

this case, the California Court of Appeal concluded the insurance DRD was "unquestionably discriminatory on its face." *Id.* at 887. Finally, the *Ceridian* court found the FTB's concession that the compensatory tax defense was not applicable to the insurance DRD was "well taken" since, in the court's view, the FTB could not have met the three-pronged test required by that defense. *Id.* at 886.

B. The Decision Below Is Compelled by This Court's Decision in *Fulton*

The decision below (and the decisions of other courts that reached the same conclusion) is compelled by this Court's decision in *Fulton*.

In *Fulton*, this Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock. The tax was imposed at the rate of 0.25 percent of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. Under this regime, if the stock was issued by a corporation doing all of its business in North Carolina, a 100 percent reduction of the value of the stock would be allowed; if the stock was issued by a corporation doing 50 percent of its business in North Carolina, a 50 percent reduction of the value of the stock would be allowed; and if the stock was issued by a corporation doing none of its business in North Carolina, no reduction of the value of the stock would be allowed. The Court had no hesitation in branding North Carolina's taxing scheme as "facially" discriminatory:

> A regime that taxes stock only to the degree that its issuing corporation participates in interstate

> commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Fulton, 516 U.S. at 333.

California's DRD suffers from precisely the same constitutional infirmity. It permits a taxpayer a DRD only to the extent that the dividend-paying corporation does business in California. Thus, just as in North Carolina, the taxpayer receives a benefit only insofar as the corporation in which it has invested is doing business in the taxing state. If the dividend-paying corporation were doing all of its business in California, a taxpayer would be entitled to a 100 percent DRD; if the dividend-paying corporation were doing 50 percent of its business in California, a taxpayer would be entitled to a 50 percent DRD; and if the dividend-paying corporation were doing none of its business in California, no DRD would be allowed. The Court's conclusion with regard to the North Carolina regime applies equally to the California regime:

> A regime that [denies a DRD] only to the degree that [the dividend-paying corporation] participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Id. Accordingly, California's limited DRD also "facially discriminates against interstate commerce." *Id.*

In *Fulton,* North Carolina maintained that the intangibles tax should nonetheless be sustained because it

satisfied each of the three conditions of the compensatory tax doctrine. *Id.* at 334. For reasons that are controlling here (and on which the court below relied), this Court found that, in fact, none of these three required conditions had been satisfied.

First, the Court observed that where a state identifies an intrastate tax as the basis for a proposed compensatory tax defense, "it should go without saying that this intrastate tax must serve some purpose for which the State may otherwise impose a burden on interstate commerce." *Id.* This requirement defeated North Carolina's attempt to offer its general corporate income tax as a compensatory burden for its intangibles tax because "North Carolina ha[d] no general sovereign interest in taxing income earned out of state." *Id.* California likewise has "no general sovereign interest in taxing income earned out of state," and it therefore cannot justify a tax on dividends paid to California taxpayers by its inability to tax the out-of-state earnings from which those dividends are derived.

Second, the Court found that the State also failed to meet the second prong of the compensatory tax defense that the tax on interstate commerce approximate, but not exceed, the amount of the tax on intrastate commerce. In reaching its decision, the Court observed that "[w]here general forms of taxation are involved, we ordinarily cannot even begin to make the sorts of quantitative assessments that the compensatory tax doctrine requires." *Id.* at 338. The Court of Appeal in this case reached the same conclusion.

Finally, the Court concluded that the State had failed to demonstrate that the two taxes fell upon substantially equivalent events, because the levies fell upon two different

parties. Precisely the same lack of "equivalence" exists here because the two allegedly complementary taxes – the tax on the dividend-paying corporation's income and the tax on the dividend-recipient's income – fall on different taxpayers, namely, the payor and the payee.

Fulton remains sound law. Certainly, all three state courts that have reviewed limited DRDs in the wake of *Fulton* have agreed that the decision effectively governs their results. In light of this conformity and the close match between this case and the issues addressed in *Fulton*, the FTB's Petition offers no compelling reason for the Court's intervention in this litigation. Sup. Ct. R. 10.

THE QUESTIONS POSED BY THE STATE WOULD NEITHER PROVIDE IMPORTANT GUIDANCE NOR CONTROL THE RESULT IN THIS CASE

In light of the fact that there is a unanimous body of judicial authority supporting the decision below, which is dictated by this Court's decision in *Fulton*, the FTB is compelled to rest its Petition on an invitation for this Court to explore two esoteric questions relating to the application of the compensatory tax doctrine, neither of which requires this Court's guidance. The first – "whether the compensatory tax defense has application when a single levy is involved" (Pet. 15) – is not even in dispute. The uniform line of decisions, including that of the Court of Appeal below, rejected the compensatory tax defense on the merits, not because it was purportedly inapplicable to a single levy.

As to the second question on which the FTB seeks this Court's guidance – "whether a tax on a corporation is . . . equivalent to a tax on the dividend income received by

shareholders" (Pet. 16) – the Court effectively resolved the question in *Fulton*, roundly rejecting the State's effort to analogize a tax on a corporation to a tax on its shareholders. Moreover, insofar as the Court acknowledged that the questions might be open as a matter of "principle," *Fulton*, 516 U.S. at 341, the record here provides no stronger basis for such an inquiry than did the record in *Fulton*.

As the Court observed in *Fulton*, the question posed by the FTB involves "complex factual inquiries" that courts "are poorly equipped to evaluate with precision" because the question, at bottom, is whether the economic incidence of a tax should be treated as different than the nominal incidence of that tax. *Id.* at 341-42. The record here is totally bereft of any facts, let alone expert analysis, which would allow a trial court, much less this Court, to even begin such an evaluation. Indeed, the Court of Appeal in this case commented that the FTB had failed altogether to "offer any factual or logical support for its claim that the actual incidences of these two taxes are imposed upon the same class of taxpayers." (Ct. App. Op., Pet. App. 21.)

Moreover, even if the FTB could prevail on this question, it would be of no moment here, because the question goes only to one of the three prongs of the compensatory tax defense. There can be no dispute that California's limited DRD flunked the other two prongs of the test. (Ct. App. Op., Pet. App. 16-20.) One does not pass the compensatory tax test with a grade of 33-⅓ percent.

CONCLUSION

In its Petition, the FTB fails to provide any basis, much less a compelling reason, for granting certiorari. This Court's ruling in *Fulton* compelled the decision reached on the merits below. The California Court of Appeal here, just as each other state court that has considered the constitutionality of a limited DRD, closely adhered to the analysis in *Fulton* and, by striking down the limited DRD as discriminatory against interstate commerce in violation of the Commerce Clause, arrived at the same result. The Petition accordingly should be denied.

Respectfully submitted,

THOMAS H. STEELE
(*Counsel of Record*)
ANDRES VALLEJO
MORRISON & FOERSTER LLP
425 Market Street
San Francisco, CA 94105
(415) 268-7000 Fax: (415) 268-7522

ROBIN C. CAMPBELL
ANGLIN, FLEWELLING, RASMUSSEN,
CAMPBELL & TRYTTEN LLP
199 South Los Robles Avenue,
Suite 600
Pasadena, CA 91101
(626) 535-1900 Fax: (626) 577-7764

Attorneys for Respondent
Farmer Bros. Co.

APPENDIX A

D.D.I., Inc., Danov Corporation, and Estuary Corporation, Florida corporations, Plaintiffs and Appellees v. State of North Dakota, by and through its Tax Commissioner, Rick Clayburgh, Defendant and Appellant

No. 20020241

SUPREME COURT OF NORTH DAKOTA

2003 ND 32; 657 N.W.2d 228; 2003 N.D. LEXIS 39

March 5, 2003, Filed

PRIOR HISTORY: Appeal from the District Court of Burleigh County, South Central Judicial District, the Honorable Robert O. Wefald, Judge.

DISPOSITION: Affirmed.

COUNSEL: William P. Pearce (appeared), Pearce & Durick, Bismarck, N.D., Richard A. Husseini (argued), Geoffrey Schultz (appeared), James Edward Maloney (on brief), Maryanne Lyons (on brief), Baker Botts L.L.P., Houston, TX, Gerard Desrochers (on brief), Houston, TX, for plaintiffs and appellees.

Donnita A. Wald (argued), Special Assistant Attorney General and Robert W. Wirtz (appeared), Special Assistant Attorney General, Tax Department, Bismarck, N.D., for defendant and appellant.

JUDGES: Opinion of the Court by Kapsner, Justice. Carol Ronning Kapsner, Dale V. Sandsrom, William A. Neumann, Mary Muehlen Maring, Gerald W. VandeWalle, C.J.

OPINION BY: Carol Ronning Kapsner

OPINION: Kapsner, Justice.

The State of North Dakota, by and through its Tax Commissioner ("Commissioner"), appealed from a judgment declaring the dividends received deduction in N.D.C.C. § 57-38-01.3(1)(g) unconstitutional and enjoining collection of the Commissioner's assessments of corporate income tax against D.D.I., Inc., Danov Corporation, and Estuary Corporation (collectively referred to as "taxpayers").[1] We hold the dividends received deduction is not a valid compensatory tax and violates the Commerce Clause. We affirm.

I

The taxpayers are Florida corporations engaged in managing assets, including oil and gas properties in North Dakota, and they pay North Dakota corporate income taxes on their net income from business done by them in North Dakota. The taxpayers also receive dividend income from other corporations conducting business either wholly or primarily outside of North Dakota. D.D.I. and Estuary initially excluded the dividends received from those other corporations in the calculation of their North Dakota corporate income tax for tax years 1989 through 1997, and Danov excluded those dividends for tax years 1989 through 1995. The Commissioner determined those dividends were business income subject to apportionment, and to the extent the Commissioner determined the dividends were includable in the taxpayers' North Dakota apportioned income, the Commissioner applied the dividends

[1] The Commissioner has not separately raised or argued the appropriateness of the injunctive relief granted by the district court. We, therefore, do not address the issue.

received deduction under N.D.C.C. § 57-38-01.3(1)(g), which authorizes adjustments to a corporation's taxable income and provides:

> 1. The taxable income of a corporation as computed pursuant to the provisions of the Internal Revenue Code of 1954, as amended, must be:
>
> . . . .
>
> g. Reduced by dividends or income received by any person from stock or interest in any corporation, the income of which has been assessed and paid by a corporation under this chapter or sections 57-35.3-01 through 57-35.3-12, received by the taxpayer and included in the gross income within the income year if such corporation has reported the name and address of each person owning stock and the amount of dividends or income paid each such person during the year, but when only part of the income of any corporation has been assessed and income tax paid under this chapter or sections 57-35.3-01 through 57-35.3-12, only a corresponding part of the dividends or income received therefrom may be deducted.

The taxpayers brought this declaratory judgment action against the Commissioner, claiming the dividends received deduction violated the Commerce Clause. The trial court concluded the dividends received deduction violated the "negative" or "dormant" aspect of the Commerce Clause because the deduction was similar to a North Carolina "intangibles tax" held unconstitutional in *Fulton Corp. v. Faulkner,* 516 U.S. 325, 133 L. Ed. 2d 796, 116 S. Ct. 848 (1996). The Commissioner appealed.

II

The Commerce Clause, U.S. Const. art. I, § 8, cl. 3, grants Congress the power "[t]o regulate commerce . . . among the several States." Although the Commerce Clause is phrased as a grant of power to Congress, it has long been understood to have a "negative" or "dormant" aspect that denies states the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce. *Fulton,* 516 U.S. at 330; *Oregon Waste Sys., Inc. v. Department of Envtl. Quality,* 511 U.S. 93, 98, 128 L. Ed. 2d 13, 114 S. Ct. 1345 (1994). The Commerce Clause grants Congress plenary authority over interstate commerce to avoid the economic balkanization that had plagued relations among the colonies and later among the states under the Articles of Confederation. *Oregon Waste,* 511 U.S. 93 at 98. The "negative" or "dormant" aspect of the Commerce Clause prohibits economic protectionism designed to benefit in-state economic interests by burdening out-of-state competitors. *Fulton,* 516 U.S. 325 at 330.

In *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 288-89, 51 L. Ed. 2d 326, 97 S. Ct. 1076 (1977), the United States Supreme Court rejected a formalistic approach to Commerce Clause challenges to state taxes. *See generally* 1 Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* ¶ 4.11[1] (3rd ed. 2001). The Court recognized that entities engaged in interstate commerce were not immune from state taxation and said "'"it was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business." *Western Live Stock v. Bureau of Revenue,* 303 U.S. 250, 254, 82 L. Ed. 823, 58 S. Ct. 546 (1938).'" *Complete Auto,* 430 U.S. 274 at 288 (quoting *Colonial Pipeline Co. v.*

Traigle, 421 U.S. 100, 108, 44 L. Ed. 2d 1, 95 S. Ct. 1538 (1975)). The Court articulated a four-part test under which a state tax would be sustained against a Commerce Clause challenge if (1) the tax was applied to an activity with a substantial nexus with the taxing state, (2) the tax was fairly apportioned, (3) the tax did not discriminate against interstate commerce, and (4) the tax was fairly related to the services provided by the state. *Complete Auto,* 430 U.S. 274 at 279, 287.

Here, the dispositive issue under that four-part test is whether the dividends received deduction discriminates against interstate commerce. In *Oregon Waste,* 511 U.S. at 99, the Court defined "discrimination" to mean "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *See also Fulton,* 516 U.S. at 331 (quoting *Chemical Waste Mgmt., Inc. v. Hunt,* 504 U.S. 334, 342, 119 L. Ed. 2d 121, 112 S. Ct. 2009 (1992) for principle that statute is discriminatory if it "taxes a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State"). State laws that facially discriminate against interstate commerce are subject to the "strictest scrutiny" and are "virtually *per se* invalid." *Fulton,* at 331, 344; *Oregon Waste,* at 99-101.

The Commissioner concedes the dividends received deduction facially discriminates against interstate commerce. A facially discriminatory tax may survive Commerce Clause scrutiny if the tax is a "compensatory" or "complementary" tax that requires interstate commerce bear a burden already born by intrastate commerce. *Fulton,* 516 U.S. 274 at 331-33. The compensatory or complementary tax doctrine assures that "'[w]hen the account is made up, the stranger from afar is subject to no

greater burdens as a consequence of ownership than the dweller within the gates. The one pays upon one activity or incident, and the other upon another, but the sum is the same when the reckoning is closed.'" *Fulton,* 516 U.S. at 332 (quoting *Henneford v. Silas Mason Co.,* 300 U.S. 577, 584, 81 L. Ed. 814, 57 S. Ct. 524 (1937)). In *Fulton,* 516 U.S. 325 at 332-33, the Court enunciated three requirements for a valid compensatory tax:

> First, "a State must, as a threshold matter, 'identify . . . the [intrastate tax] burden for which the State is attempting to compensate.'" *Oregon Waste, supra,* 511 U.S. 93 at 103 (quoting *Maryland v. Louisiana,* 451 U.S. 725, 758, 68 L. Ed. 2d 576, 101 S. Ct. 2114 (1981)). Second, "the tax on interstate commerce must be shown roughly to approximate – but not exceed – the amount of the tax on intrastate commerce." *Oregon Waste,* 511 U.S., at 103. "Finally, the events on which the interstate and intrastate taxes are imposed must be 'substantially equivalent'; that is, they must be sufficiently similar in substance to serve as mutually exclusive 'proxies' for each other." *Ibid.* (quoting *Armco Inc. v. Hardesty,* 467 U.S. 638 at 643, 81 L. Ed. 2d 540, 104 S. Ct. 2620 (1984)).

The Commissioner argues the dividends received deduction must be presumed constitutional because statutes enjoy a strong presumption of constitutionality in North Dakota, *see MCI Telecomms. v. Heitkamp,* 523 N.W.2d 548, 552 (N.D. 1994), and the taxpayers have failed to prove beyond a reasonable doubt the dividends received deduction is unconstitutional. Although there is a presumption that statutes are constitutional, facially discriminatory restrictions on interstate commerce are subject to the strictest scrutiny and are virtually per se

invalid, and the State must establish the requirements for a valid compensatory tax. *Fulton,* 516 U.S. at 332, 344; *Oregon Waste,* 511 U.S. at 99-101.

The Commissioner argues the dividends received deduction is a valid compensatory tax. The Commissioner argues the "intangibles tax" found unconstitutional in *Fulton* and the dividends received deduction in this case are not similar. We reject the Commissioner's arguments.

In *Fulton,* 516 U.S. at 328, the Supreme Court described North Carolina's "intangibles tax" on the fair market value of corporate stock owned by North Carolina residents:

> [A] corporation doing all of its business within the State would pay corporate income tax on 100% of its income, and the taxable percentage deduction allowed to resident owners of that corporation's stock under the intangibles tax would likewise be 100%. Stock in a corporation doing no business in North Carolina, on the other hand, would be taxable on 100% of its value. For the intermediate cases, holders of stock were able to look up the taxable percentage for a large number of corporations as determined and published annually by the North Carolina Secretary of Revenue (Secretary). In 1990, for example, the Secretary determined the appropriate taxable percentage of IBM stock to be 95%, meaning that IBM did 5% of its business in North Carolina, with its stock held by North Carolina residents being taxable on 95% of its value.

In *Fulton,* 516 U.S. at 334-36, North Carolina argued the "intangibles tax," with its taxable percentage deduction, compensated for the burden of the general corporate income tax paid by corporations doing business in North

Carolina. Because North Carolina had no general sovereign interest in taxing income earned out of state, however, North Carolina was required to identify some in-state activity or benefit to justify the compensatory levy. *Id.* at 334. The Supreme Court rejected North Carolina's argument that it could impose a compensatory tax on foreign corporations because they availed themselves of North Carolina's capital markets. *Id.* at 335-36. The Court said "'[p]ermitting discriminatory taxes on interstate commerce to compensate for charges purportedly included in general forms of intrastate taxation would allow a state to tax interstate commerce more heavily than in-state commerce anytime the entities involved in interstate commerce happened to use facilities supported by general tax funds.'" *Id.* at 335 (quoting *Oregon Waste,* 511 U.S. at 105 n.8). North Carolina failed to show the corporate income tax supported the maintenance of the capital market; it therefore failed to justify the use of the intangibles tax as replacement support for the market. *Fulton,* 516 U.S. 325 at 336.

The Supreme Court rejected North Carolina's claim that its intangibles tax was roughly approximate to, but did not exceed, the intrastate corporate income tax. *Fulton,* 516 U.S. at 336-38. The Court said the quantitative assessments necessary for the compensatory tax doctrine were difficult to apply to general forms of taxation:

> When a corporation doing business in a State pays its general corporate income tax, it pays for a wide range of things: construction and maintenance of a transportation network, institutions that educate the work force, local police and fire protection, and so on. The Secretary's justification for the intangibles tax, however, rests on

> only one of the many services funded by the corporate income tax, the maintenance of a capital market for the shares of both foreign and domestic corporations. To the extent that corporations do their business outside North Carolina, after all, they get little else from the State. Even, then, if we suppressed our suspicion that North Carolina actually funds its capital market through its blue sky fees, not its general corporate taxation, the relevant comparison for our analysis has to be between the size of the intangibles tax and that of the corporate income taxes component that purportedly funds the capital market.

Id. at 337-38.

The Supreme Court also rejected North Carolina's claim that its intangibles tax and its general corporate income tax fell on substantially equivalent events. *Fulton,* 516 U.S. at 338-44. The Court said it had found that equivalence only in the sales/use tax combination at issue in *Silas Mason,* but recent cases had demonstrated an extreme reluctance to recognize new compensatory categories. *Fulton,* 516 U.S. 325 at 338. The Court said the intangibles tax and general corporate income tax were different in a number of respects, including the parties ostensibly taxed, and those taxes did not satisfy the objective of the equivalent-event requirement to enable in-state and out-of-state businesses to compete on an equal footing. *Id.* at 340.

Here, N.D.C.C. § 57-38-01.3(1)(g) authorizes a dividends received deduction to a dividend recipient to the extent the dividend payor's income was subject to North Dakota corporate income tax, but does not grant a dividends received deduction to a dividend recipient if the dividend payor's income was not subject to North Dakota

corporate income tax. The Commissioner argues the intrastate tax burden for which the dividends received deduction attempts to compensate is the North Dakota corporate income tax paid by a North Dakota corporation that distributes the already taxed corporate profits as a dividend. The Commissioner argues the dividends received deduction compensates for the tax already paid on North Dakota income by the North Dakota corporation paying that dividend. The Commissioner argues "only one level of North Dakota income tax should be imposed on North Dakota income. The [dividends received deduction] insures that, in the end, there is only one level of North Dakota income tax on North Dakota income. Interstate commerce, i.e., the dividend from [an out-of-state corporation] to [taxpayers] bears the same burden . . . already borne by intrastate commerce, i.e., the dividend from [a North Dakota corporation] to [taxpayers]." The Commissioner offers the following comparative tax hypothetical, with a ten percent tax rate on North Dakota corporate income and on dividends:

	North Dakota Corporation	Out-of-State Corporation
Dividend Received by Taxpayers	$100	$100
North Dakota Corporate Income Tax on Profits out of which Dividend is Paid	$10	$0
Dividends Received Deduction	$100	$0
Taxable Dividend	$0	$100
North Dakota Corporate Income Tax on Receipt of Dividend	$0	$10

Total North Dakota Tax Paid By Dividend Payor Corporation and by Taxpayers	$10	$10

Although avoiding double taxation of North Dakota income is a permissible goal, the Commissioner has not identified any specific in-state activity or benefit received by the taxpayers to justify the compensatory levy on their dividends received from out-of-state corporations. The State of North Dakota does not have a general sovereign interest in taxing income earned out-of-state and must identify some specific in-state activity or benefit to justify a compensatory levy. *Fulton,* 516 U.S. at 334. The Commissioner has failed to establish such an in-state benefit to the taxpayers.

The Commissioner's comparative tax hypothetical ignores the corporate income tax that an out-of-state corporation's state might impose on the out-of-state corporation's profits, which effectively imposes a double layer of tax on the out-of-state income but not on the in-state income. The risk of multiple taxation may be considered in assessing a Commerce Clause claim, *see Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425, 444, 63 L. Ed. 2d 510, 100 S. Ct. 1223 (1980); 1 Hellerstein and Hellerstein, ¶ 4.08[1][a], and in considering whether a tax is discriminatory, the United States Supreme Court has applied the "internal consistency" doctrine. *Armco Inc. v. Hardesty,* 467 U.S. 638, 644, 81 L. Ed. 2d 540, 104 S. Ct. 2620 (1984). *See American Trucking Ass'ns, Inc. v. Scheiner,* 483 U.S. 266, 283, 97 L. Ed. 2d 226, 107 S. Ct. 2829 (1987); *Tyler Pipe Indust. Inc. v. Washington State Dep't of Rev.,* 483 U.S. 232, 241, 97 L. Ed. 2d 199, 107 S. Ct. 2810 (1987). *See generally* 1 Hellerstein and Hellerstein, ¶ 4.15[1]. The internal consistency doctrine requires

that the imposition of a tax identical to a challenged tax in every state would add no burden to interstate commerce that intrastate commerce did not also bear, and looks at the structure of the challenged tax to see whether its identical application by every state would place interstate commerce at a disadvantage against intrastate commerce. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185, 131 L. Ed. 2d 261, 115 S. Ct. 1331 (1995). The internal consistency test does not require other states to actually impose a similar tax to place a burden on interstate commerce; rather, a tax that exposes a taxpayer to a risk of multiple taxation is invalid under the Commerce Clause. *See Scheiner,* 483 U.S. 266 at 285; *Tyler Pipe,* 483 U.S. 232 at 241; *Armco,* 467 U.S. 638 at 644-45. *See also* 1 Hellerstein and Hellerstein, at ¶ 4.15[1][a].

Here, when the effect of the corporate income tax that an out-of-state corporation's state might impose on the out-of-state corporation's profits is considered, the dividends received deduction does not avoid double taxation for out-of-state corporate income and does not roughly approximate the tax on intrastate commerce under the Commissioner's comparative tax hypothetical. We conclude the dividends received deduction does not satisfy the first two elements of the compensatory tax doctrine, and we need not address whether the interstate and intrastate taxes are imposed on substantially equivalent events. *See Fulton,* 516 U.S. at 340 (stating general corporate income tax and intangibles tax are different in a number of obvious aspects, including the parties ostensibly taxed). We conclude the dividends received deduction is not a valid compensatory tax.

III

Relying on *Oregon Waste,* 511 U.S. at 100-01 and *New Energy Co. v. Limbach,* 486 U.S. 269, 278, 100 L. Ed. 2d 302, 108 S. Ct. 1803 (1988), the Commissioner nevertheless argues the dividends received deduction is valid because it serves a legitimate local purpose of preventing double taxation which cannot be served by reasonable nondiscriminatory alternatives.

However, *Oregon Waste* does not apply an alternative commerce clause test for compensatory tax cases. In *Oregon Waste,* 511 U.S. at 100-01 (quoting *Limbach,* 486 U.S. at 278), the Court said if a state regulation discriminates against interstate commerce, the regulation is analyzed under the "virtually *per se* rule of invalidity," and the regulation must be invalidated unless the State can "'show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.'" The Court said justifications for discriminatory restrictions on commerce must pass the "strictest scrutiny", the State's burden of justification is so heavy that facial discrimination by itself may be a fatal defect, and the compensatory tax doctrine "is merely a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means." *Oregon Waste,* 511 U.S. at 100-02. Under *Oregon Waste,* the compensatory tax doctrine was the test applied for analyzing justification of a facially discriminatory tax. Moreover, although avoiding double taxation of North Dakota income is a legitimate legislative goal, "the purpose of, or justification for, a law has no bearing on whether it is facially discriminatory." *Oregon Waste,* at 100. We have concluded the method employed by the State of North Dakota

impermissibly discriminates against interstate commerce. Taxpayers have asserted and the Commissioner does not dispute there are nondiscriminatory means to accomplish the goal of avoiding double taxation on North Dakota corporate income.

IV

We conclude the dividends received deduction is not a valid compensatory tax and impermissibly discriminates against interstate commerce; therefore, N.D.C.C. § 57-38-01.3(1)(g) violates the Commerce Clause of the United States Constitution and is invalid.[2] We affirm the district court judgment.

Carol Ronning Kapsner
Dale V. Sandstrom
William A. Neumann
Mary Muehlen Maring
Gerald W. VandeWalle, C.J.

---

[2] Having declared subsection (g) unconstitutional has no effect on the remainder of the statute. *See* N.D.C.C. § 1-02-20. *See also Montana-Dakota Utils. Co. v. Johanneson*, 153 N.W.2d 414, 424-25 (N.D. 1967).

APPENDIX B

LEXSEE 85 CAL APP 4TH 875

CERIDIAN CORPORATION, Plaintiff and Respondent, v. FRANCHISE TAX BOARD, Defendant and Appellant.

No. A084298.

COURT OF APPEAL OF CALIFORNIA, FIRST APPELLATE DISTRICT, DIVISION THREE

85 Cal. App. 4th 875; 102 Cal. Rptr. 2d 611; 2000 Cal. App. LEXIS 974; 2000 Cal. Daily Op. Service 10156; 2000 Daily Journal DAR 13563

December 21, 2000, Decided

SUBSEQUENT HISTORY:

As Modified on Denial of Rehearing January 18, 2001, Reported at: 2001 Cal. App. LEXIS 27. No Change in Judgment.

PRIOR HISTORY: Superior Court of the City and County of San Francisco. Super. Ct. No. 983-377. Carlos Bea, Judge.

DISPOSITION: We hold that Revenue and Taxation Code section 24410 is an unconstitutional enactment in that it violates the commerce clause both by allowing a deduction for insurance subsidiary dividends only to corporations domiciled in California, and in limiting the amount of the deduction according to a formula based on the subsidiary's gross receipts, payroll and property within the state. The trial court's judgment invalidating the statute and awarding Ceridian the stipulated amount of tax refund is affirmed.

COUNSEL: Bill Lockyer, Attorney General, Randall P. Borcherding and Julian O. Standen, Deputy Attorneys General, for Defendant and Appellant.

Preston, Gate & Ellis, James P. Kleier and Julie A. Aguilar for Plaintiff and Respondent.

Morrison & Foerster, Thomas H. Steele, Amy L. Silverstein and Mariah A. Panza for Wells Fargo & Company as Amicus Curiae on behalf of Plaintiff and Respondent.

Wm. Gregory Turner for California Taxpayers' Association as Amicus Curiae on behalf of Plaintiff and Respondent.

JUDGES: Opinion by Parrilli, J., with McGuiness, P.J., and Walker, J., concurring.

OPINION BY: Parrilli

OPINION:

PARRILLI, J.

In this case we hold that Revenue and Taxation Code section 24410 violates the commerce clause of the United States Constitution.

The Franchise Tax Board of the State of California (Board) appeals from a judgment awarding a refund to Ceridian Corporation (Ceridian). The trial court ruled that the statute governing taxation of insurance company dividends paid to major corporate stockholders is unconstitutional. The Board claims this ruling was erroneous, and also contends that even if the statute is invalid, a tax refund is not the proper remedy. We agree with the trial court on both issues and affirm the judgment.

I. FACTS

Ceridian, formerly Control Data Corp. (Control Data), sought a refund of corporate franchise taxes imposed upon Control Data for the income years 1978 through 1982, and upon Commercial Credit Company (Commercial Credit) for the income years 1978 and 1979. Ceridian is the successor to all causes of action and rights asserted herein on behalf of Control Data and Commercial Credit. Ceridian is a Delaware corporation, with its commercial domicile in Minnesota. Commercial Credit is a Delaware corporation with its commercial domicile in Maryland. During the income years at issue, Commercial Credit was a wholly owned subsidiary of Control Data.

During the income years 1978 through 1982, Control Data was engaged in the business of manufacturing and selling computers, computer systems and peripheral equipment, and in providing computer-related services. Commercial Credit was engaged, through its subsidiaries, in the business of providing financial services and insurance to businesses and individual customers.

Control Data and Commercial Credit filed separate California Bank and Corporation Tax returns for themselves and their wholly owned groups for 1978 and 1979. Thus, each entity calculated its own business income and apportioned income to California based upon the averages of its California property, payroll and sales as a percentage of total property, payroll and sales. For the tax years 1980 through 1982, Control Data and Commercial Credit filed California corporate franchise tax returns on the combined report method. Under this method, the taxable business income for Control Data and Commercial Credit was combined, and then apportioned to California based upon

the averages of their combined California property, payroll and sales as a percentage of total combined property, payroll and sales.

In 1985, the Board recomputed the California tax liabilities of Control Data and Commercial Credit for the income years 1978 and 1979 on the basis that a combined report should have been filed, rather than separate returns. Additionally, the Board determined that business income included on these combined returns, as well as the combined returns filed for the 1980 through 1982 years, should have included approximately $78 million in dividends received from the insurance company subsidiaries. Ceridian paid the disputed amount and exhausted its administrative remedies.

On December 19, 1996, Ceridian filed a complaint for refund of taxes, alleging that taxation of Commercial Credit's insurance subsidiary dividends violated due process and the commerce clause of the federal Constitution. The case came before the trial court on stipulated facts. On May 7, 1998, the court issued its tentative decision, finding that Revenue and Taxation Code section 24410 is facially discriminatory and violates the commerce clause. The court awarded Ceridian a tax refund in the stipulated amount of $556,442. Judgment was entered accordingly (Code Civ. Proc., § 632; Cal. Rules of Court, rule 232), and the Board filed a timely notice of appeal.

II. DISCUSSION

A. *Constitutional Validity of Section 24410*

1. *The Revenue and Taxation Code*[1]

With certain exceptions, every corporation doing business in California pays an annual franchise tax measured by its net income. (§ 23151.) When that income is derived from or attributable to sources both within and outside the state, it is apportioned in accordance with the Uniform Division of Income for Tax Purposes Act (§ 25120 et seq.). (§§ 25101, 25121.) The Act's allocation formula is based on the proportion of a corporation's total property, payroll and sales which are located in the state. (§§ 25128-25136.) In computing its taxable income, a corporation may deduct "[d]ividends declared from income under franchise, alternative minimum, or income taxes." (§§ 24401, 24402.) The purpose of this dividend deduction is "to avoid double taxation *at the corporate level* of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation. [Citations.]" (*Safeway Stores, Inc. v. Franchise Tax Board* (1970) 3 Cal. 3d 745, 749-750 [91 Cal. Rptr. 616, 478 P.2d 48] italics in original (*Safeway Stores*).)

In lieu of the corporate franchise tax, insurance companies pay an annual tax based on the amount of gross premiums, less return premiums, received upon business done in this state. (§ 12221; Cal. Const., art. XIII, § 28.) The statute at issue in this case allows a deduction in computing taxable income (§ 24401) for "Dividends received

---

[1] Unless otherwise indicated, all further statutory references are to the Revenue and Taxation Code.

by a corporation commercially domiciled in California, during the income year from an insurance company subject to tax imposed by [the "Insurance Taxation" part] of this division at the time of the payment of the dividends and at least 80 percent of each class of its stock then being owned by the corporation receiving the dividend." (§ 24410, subd. (a).) The deduction is "limited to that portion of the dividends received which are determined to be paid from income from California sources determined pursuant to subdivision (c)." (§ 24410, subd. (b).) The apportionment formula set out in subdivision (c) uses the average of three factors – gross receipts, payroll, and property – to determine an insurance company dividend payor's gross income from California sources, which is then used to determine the amount of dividends paid from California sources.[2] The parties herein stipulated that for

---

[2] In pertinent part, section 24410 establishes a deduction for: "(a) Dividends received by a corporation commercially domiciled in California, during the income year from an insurance company subject to tax imposed by Part 7 (commencing with Section 12001) of this division at the time of the payment of the dividends and at least 80 percent of each class of its stock then being owned by the corporation receiving the dividend. [¶] (b) The deduction under this section shall be limited to that portion of the dividends received which are determined to be paid from income from California sources determined pursuant to subdivision (c). [¶] (c) Dividends paid from California sources shall be determined by multiplying the amount of the dividends by an apportionment factor equal to the ratio of gross income from California sources to all gross income of the company. Gross income from California sources equals total gross income less dividends from other insurance companies multiplied by the average of the following three factors: [¶] (1) A gross receipts factor, the denominator of which shall include all receipts, other than dividends from another insurance company, regardless of the nature or source from which derived. The numerator of which shall include all gross receipts, other than dividends from another insurance company, derived from or attributable to this state.

(Continued on following page)

purposes of subdivision (b), "for each of the years at issue, the average percentage of the payroll, property and gross receipts in California of each insurance company paying dividends" to Ceridian is 1.77 percent.

2. *The Commerce Clause*

The Constitution gives Congress the power to regulate commerce between the states. (U.S. Const., art. I, § 8, cl. 3.) "Though phrased as a grant of regulatory power to Congress, the [Commerce] Clause has long been understood to have a 'negative' aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce. [Citations.]" (*Oregon Waste Systems, Inc. v. Department of Environmental Quality of the State of Ore.* (1994) 511 U.S. 93, 98 [114 S. Ct. 1345, 1349, 128 L. Ed. 2d 13] (*Oregon Waste*).) "This 'negative' aspect of the Commerce Clause prohibits

---

With respect to premiums, only receipts which were subject to tax under Part 7 (commencing with Section 12001) of this division, shall be included in the numerator, and with respect to income from intangibles they shall be attributable to the commercial domicile of the insurance company. [¶] (2) A payroll factor determined under the provisions of the Uniform Division of Income for Tax Purposes Act, Chapter 17, Article 2 of this part. [¶] (3) A property factor, determined under the provisions of the Uniform Division of Income for Tax Purposes Act provided for in Article 2 (commencing with Section 25120) of Chapter 17 of this part, provided that for the purposes of this paragraph the property factor shall include all intangible investment property, which intangible property shall be allocated to the commercial domicile of that insurance company. [¶] (4) Plus the portion of the dividends received from another insurance company determined to be paid from California source income pursuant to the formula set forth in paragraphs (1) through (3) based upon the receipts, payroll and property of that other insurance company."

economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors. [Citations.] Thus, state statutes that clearly discriminate against interstate commerce are routinely struck down [citations], unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism [citation]." (*New Energy Co. of Indiana v. Limbach* (1988) 486 U.S. 269, 273-274 [108 S. Ct. 1803, 1807-1808, 100 L. Ed. 2d 302].) Supreme Court cases "leave open the possibility that a State may validate a statute that discriminates against interstate commerce by showing that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. [Citations.] This is perhaps just another way of saying that what may appear to be a 'discriminatory' provision in the constitutionally prohibited sense – that is, a protectionist enactment – may on closer analysis not be so. However it be put, the standards for such justification are high. [Citations.]" (*Id.* at pp. 278-279 [108 S. Ct. at p. 1810]; see also *Hughes v. Oklahoma* (1979) 441 U.S. 322, 337 [99 S. Ct. 1727, 1737, 60 L. Ed. 2d 250] [facial discrimination invokes "strictest scrutiny."]

3. *Discriminatory Taxation*

Under the commerce clause, "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." (*Armco Inc. v. Hardesty* (1984) 467 U.S. 638, 642 [104 S. Ct. 2620, 2622, 81 L. Ed. 2d 540].)

As it did below, the Board essentially concedes that subdivision (a) of section 24410, which allows only corporations "commercially domiciled" in California to deduct certain insurance company dividends from their taxable income, violates the commerce clause.[3] We agree that subdivision (a) violates the commerce clause because it limits the pertinent deduction to those corporations "commercially domiciled" in California. Thus, the only disputed issue in this case is whether subdivision (b), which limits the deduction to dividends "paid from income from California sources" also violates the commerce clause. We conclude that it does.

The trial court found section 24410, subdivision (b) "patently discriminatory," because "[o]n its face, this taxing scheme discriminates against the owner of insurance companies which do business in California, but retain their property and payroll in other states, on no basis other than their refusal to relocate their property and payroll to California." The Board contends, on the contrary, that subdivision (b) is a constitutionally valid means of avoiding double taxation, analogous to that provided for noninsurance subsidiaries by section 24402 (*ante,* p. 881). The Board claims subdivision (b) does not discriminate against or burden interstate commerce, but levels the playing field between corporate taxpayers receiving

---

[3] However, the Board is constitutionally compelled to enforce the provision until it is judicially invalidated: "An administrative agency, . . . has no power: [¶] (a) To declare a statute unenforceable, or refuse to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional; [¶] (b) To declare a statute unconstitutional. . . . " (Cal. Const., art. III, § 3.5, subds.(a) & (b).)

dividends from insurance companies doing business in California, which are subject to the gross premiums tax, and those receiving dividends from insurance companies doing business elsewhere, which are not. Were it not for subdivision (b), the Board argues, California would tax the former's income twice, and the latter's only once.

Both Ceridian and amici curiae Wells Fargo and California Taxpayers' Association (hereafter, amici) vigorously assert that section 24410, subdivision (b) does *not* prevent double taxation. However, the parties' debate about whether subdivision (b) does or does not prevent double taxation misses the mark. The issue is not whether subdivision (b) serves some legitimate purpose, but whether it survives a commerce clause challenge. Significantly, the Board's authorities do not stand for the proposition that a commerce clause challenge would be overcome even if subdivision (b) prevented double taxation.

For example, the case of *United States v. Woodmansee* (N.D.Cal. 1975) 388 F. Supp. 36 (revd. in *United States v. Woodmansee* (9th Cir. 1978) 578 F.2d 1302), cited for the proposition that "the protection of competition has been recognized as a legitimate goal of tax laws intended to avoid double taxation," concerns a *federal* statute and thus does not present a negative commerce clause problem.

Moreover, a tax may violate the commerce clause even if it has no discriminatory goal or intent, if it is facially discriminatory, or has the *effect* of unduly burdening interstate commerce. (*Amerada Hess Corp. v. N.J. Taxation Div.* (1989) 490 U.S. 66, 75 [109 S. Ct. 1617, 1622-1623, 104 L. Ed. 2d 58].) "Absent a compelling justification . . . a State may not advance its legitimate goals by means that facially discriminate against [interstate] commerce.

[Citations.]" (*Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue and Finance* (1992) 505 U.S. 71, 81, [112 S. Ct. 2365, 2371, 120 L. Ed. 2d 59].)

The Board asserts that section 24402 (the general dividend deduction statute) "has been recognized as a valid means of avoiding double taxation." Accepting arguendo the Board's characterization of section 24402 as the "counterpart" of section 24410 (see *ante*, p. 620, fn. 6), none of the cases cited by the Board concerned a commerce clause challenge, nor did they hold that section 24402 is a constitutionally valid means of avoiding double taxation. (See *Safeway Stores, supra,* 3 Cal. 3d at pp. 749-750; *Great Western Financial Corp. v. Franchise Tax Bd.* (1971) 4 Cal. 3d 1, 6 [92 Cal. Rptr. 489, 479 P.2d 993]; *Max Factor & Co. v. Franchise Tax Bd.* (1973) 35 Cal. App. 3d 7, 11 [110 Cal. Rptr. 536].)

The Board relies primarily on a footnote in a 65-year-old Supreme Court case. In *Colgate v. Harvey* (1935) 296 U.S. 404 [56 S. Ct. 252, 80 L. Ed. 299, 102 A.L.R. 54] (*Colgate*), the court looked at a Vermont statute that "impose[d] a tax upon dividends earned outside the State of Vermont, while exempting from the tax dividends earned within the state," and also "discriminate[d] in favor of money loaned within the state as against money loaned outside the state [.]" (*Id.* at pp. 418-419 [56 S. Ct. at p. 252].) The court considered challenges to the statute under both the equal protection and privileges and immunities clauses of the Fourteenth Amendment. (*Id.* at p. 419 [56 S. Ct. at p. 254].) In a footnote, the court remarked, "The further point is made that the discrimination in respect of dividends and interest upon loans is a regulation of interstate commerce and therefore void under the commerce clause of the federal Constitution. But we

mention this latter claim only to reject it as without merit, since clearly a tax upon income is not an interference with interstate commerce simply because the income is derived from a source within another state; and moreover, if there be any tendency to interfere with such commerce it is purely collateral and incidental. [Citations.]" (*Ibid.*, fn. 2. [56 S. Ct. at p. 254].) The court went on to uphold the dividends provision, but invalidate the interest provision (*id.* at p. 436 [56 S. Ct. at pp. 261-262]); it later overruled *Colgate* insofar as it had found therein a violation of the privileges and immunities clause (*Madden v. Kentucky* (1940) 309 U.S. 83, 93 [60 S. Ct. 406, 410-411, 84 L. Ed. 590, 125 A.L.R. 1383]).

Later still, a federal appeals court rejected the appellants' reliance on footnote 2 of *Colgate, supra,* 296 U.S. at page 419. The appeals court noted that Supreme Court decisions in the half-century after *Colgate* was decided confirmed the district court's finding that *Colgate*'s "collateral" or "direct-indirect" test had been replaced by "the more realistic inquiry of whether a law 'substantially affects' interstate commerce." (*Dominion Nat. Bank v. Olsen* (6th Cir. 1985) 771 F.2d 108, 111.) A concurring judge went further, asserting that the *Colgate* commerce clause analysis, emphasizing whether a state directly taxed interstate commerce rather than whether it created a competitive advantage for local business, "has been overruled *sub silentio*" and "no longer is good law." (*Id.* at pp. 118, 119, conc. opn. of Contie, J.).)

4. *Subdivision (b) violates the Commerce Clause*

Under modern Supreme Court jurisprudence, a tax scheme may survive a commerce clause attack only when

it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, *does not discriminate against interstate commerce,* and is fairly related to the services provided by the State." (*Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274, 279 [97 S. Ct. 1076, 1079, 51 L. Ed. 2d 326], italics added.) "If a restriction on commerce is discriminatory, it is virtually *per se* invalid. [Citations.]" (*Oregon Waste, supra,* 511 U.S. at p. 99 [114 S. Ct. at p. 1350].) Nevertheless, a facially discriminatory tax scheme "may be saved from constitutional infirmity if it is a valid 'compensatory tax' designed simply to make interstate commerce bear a burden already borne by intrastate commerce." (*Associated Industries of Mo. v. Lohman* (1994) 511 U.S. 641, 647 [114 S. Ct. 1815, 1821, 128 L. Ed. 2d 639].)[4] "To justify a charge on interstate commerce as a compensatory tax, a State must, as a threshold matter, 'identify the intrastate tax burden for which the state is attempting to compensate.' [Citation.] Once that burden has been identified, the tax on interstate commerce must be shown roughly to approximate – but not exceed – the amount of the tax on intrastate commerce. [Citation.] Finally, the events on which the interstate and intrastate taxes are imposed must be 'substantially equivalent'; that is, they must be sufficiently similar in substance to serve as mutually exclusive 'proxies' for each other. [Citation.]" (*Oregon Waste, supra,* 511 U.S. at p. 103 [114 S. Ct. at p.

[4] The Board thus misspeaks when it cites *United States v. Salerno* (1987) 481 U.S. 739, 745 [107 S. Ct. 2095, 2100, 95 L. Ed. 2d 697] for the proposition that a "facially discriminatory law" is one which cannot under any circumstances be applied constitutionally. It is, of course, a facially *unconstitutional* law which, by definition, cannot be constitutionally applied.

1352], internal brackets and ellipses omitted; see also *Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, 332 [116 S. Ct. 848, 854, 133 L. Ed. 2d 796 (*Fulton.*)

Significantly, the Board is not contending that the tax scheme under consideration here can be justified as a "compensatory tax." Indeed, the Board has gone so far as to disclaim this position in its reply brief, stating that "*Fulton* is distinguishable because this appeal does not involve a tax on interstate commerce intended to compensate for the burden on intrastate commerce imposed by a different tax."

(see fn. 5.) This concession is well taken, since the tax scheme at issue does not meet the three requirements for a "compensatory tax."[5]

---

[5] First, to justify a tax scheme as "compensatory," *the state* has the responsibility to identify the intrastate tax burden for which the state is attempting to compensate. (*Fulton, supra,* 516 U.S. at p. 334 [116 S. Ct. at p. 855].) Here, the state has not only failed to identify such a tax burden, it has explicitly disclaimed that the tax scheme at issue in this case was designed "to compensate for the burden on intrastate commerce imposed by a different tax."

Second, to invoke the "compensatory tax defense" the state must show that the tax on interstate commerce roughly approximates, but does not exceed, the amount of the tax on intrastate commerce. (*Fulton, supra,* 516 U.S. at pp. 334, 335 [116 S. Ct. at pp. 855, 855-856].) The Board produced no proof whatsoever on this subject at trial or on appeal.

Finally, the state must show that the "compensating taxes" fall on substantially equivalent events, meaning they must be sufficiently similar in substance to serve as mutually exclusive "proxies" for each other. (*Fulton, supra,* 516 U.S. at pp. 332, 338 [116 S. Ct. at pp. 854, 857].) The state does contend that the California insurance premium tax scheme is a "proxy" for the California franchise tax. But even if this were true, the insurance premium tax scheme cannot qualify as a

(Continued on following page)

Instead, the Board's contention is that section 24410, subdivision (b) "does not discriminate against interstate commerce" and thus it is not even necessary to reach the "compensatory tax defense" issue. In other words, the Board is contending that the statute is not discriminatory because it avoids double taxation. This is a non-sequitur. If subdivision (b) discriminates against interstate commerce, as we conclude it does, then it is virtually per se invalid *unless* it is a component of a valid "compensatory tax." The fact that the tax scheme may serve some other laudatory purpose does not save it from a commerce clause challenge.

Both Ceridian and amici rely heavily on *Fulton, supra,* 516 U.S. 325. In that case, the United States Supreme Court considered a North Carolina statute that imposed a one quarter of one percent "intangibles" tax on the fair market value of corporate stock owned by North Carolina residents. However, North Carolina residents were allowed to calculate their tax liability under this provision by "taking a taxable percentage deduction equal to the fraction of the issuing corporation's income subject to tax in North Carolina." (*Id.* at p. 327-328 [116 S. Ct. at p. 852]) This figure was determined by looking at the proportion of the issuing corporation's sales, payroll and property located in North Carolina. The net effect of the tax scheme was that a corporation doing all of its business within North Carolina would pay corporate income taxes on 100% of its income, meaning that a North Carolina

---

"compensatory" tax since the state has utterly failed to establish the other elements of the "compensatory tax defense" to a facially discriminatory tax statute.

resident who owned stock in that company would avoid the "intangibles" tax entirely. At the other extreme, a North Carolina resident who owned shares in a corporation that conducted *no* business within North Carolina would have to pay the .25% tax on the full (100%) market value of the stock. Similarly, the share values of corporations that conducted some (but not all) of their business within North Carolina would be subject to a sliding scale deduction. (*Id.* at p. 328 [116 S. Ct. at p. 852].)

The *Fulton* Court determined that this tax scheme facially discriminated against interstate commerce. The court reasoned: "A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce."[6] (*Fulton, supra,* 516 U.S. at p. 333 [116 S. Ct. at p. 855].) Similarly, a statutory scheme, such as the one before us, that disallows a deduction based on the amount of *property and employees* that the dividend – declaring insurer has in another state, favors domestic corporations over their foreign competitors in raising capital among California corporations, and tends, at least, to discourage domestic corporations from plying their trade in interstate commerce, from purchasing property or hiring employees in other states, and from purchasing subsidiary insurance

[6] The Supreme Court also went on to hold that the North Carolina intangibles tax scheme was not a valid "compensatory" tax. However, since the Board has disclaimed a similar justification for the tax scheme in this case, we do not address that portion of *Fulton* in detail.

corporations that do so. Thus, section 24410, subdivision (b) is unquestionably discriminatory on its face.

In sum, the tax and deduction scheme at issue fits within *Fulton's* analytical framework. Just as in *Fulton,* here the state imposes a tax based on value derived from ownership of a corporation. Just as North Carolina reduced its intangibles tax in direct proportion to the amount of business the owned corporation did within the state's borders, so too California reduces the dividend tax to the extent such dividends are "paid from income from California sources," (§ 24410, subd. (b)), which is calculated based on the proportionate amount of property, payroll and gross receipts the owned corporation has within California. Fulton prohibits such discriminatory treatment.

Our analysis leads us to the same conclusion the trial court reached: both subdivision (a) and subdivision (b) of section 24410 place an unjustifiable burden on interstate commerce and are therefore unconstitutional.[7]

B. *Remedies*

1. *Ceridian: Refund or Retroactive Assessment*

"If a State places a taxpayer under duress promptly to pay a tax when due and relegates him to a postpayment refund action in which he can challenge the tax's legality, the Due Process Clause of the Fourteenth Amendment

[7] Since it is not at issue here, we express no opinion as to the constitutionality of section 24402.

obligates the State to provide meaningful backward-looking relief to rectify any unconstitutional deprivation." (*McKesson Corp. v. Florida Alcohol & Tobacco Div.* (1990) 496 U.S. 18, 31 [110 S. Ct. 2238, 2247, 110 L. Ed. 2d 17] (*McKesson*).) The *McKesson* court specified three ways in which a state may provide the requisite "clear and certain remedy" (*id.* at p. 40 [110 S. Ct. at p. 2252]) for its erroneous or unlawful tax collection. Under these guidelines, the Board in this case may 1) refund to Ceridian the difference between the tax it paid and the tax it would have been assessed were it allowed the same deductions its competitors actually received, 2) assess and collect back taxes from Ceridian's competitors who benefited from the deductions during the contested tax period, or 3) fashion a combination of partial refund to Ceridian and partial retroactive assessment of tax increases on its favored competitors. (*Id.* at pp. 40-41 [110 S. Ct. at pp. 2252-2253].)

A retroactive assessment remedy is codified in section 19393, which provides, in relevant part, that for franchise tax purposes, if any deduction provided for by the Bank and Corporation Tax Law (§ 23001 et seq.) "is finally adjudged discriminatory against a national banking association contrary to Section 548 of Title 12 of the United States Code,[8] or is for any reason finally adjudged invalid, or discriminatory under the California Constitution, or the laws or the Constitution of the United States,

---

[8] "For the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located." (12 U.S.C. § 548.)

the tax of the favored taxpayer shall be recomputed by the Franchise Tax Board for the taxable year in question, . . . by disallowing the deduction. . . ." The trial court was persuaded that section 19393 "has to do with banks, not insurance companies nor holding companies which hold insurance companies," and ordered a refund instead.

On appeal, the Board challenges the court's interpretation of the scope of section 19393, arguing it is not limited to banks. We need not resolve this issue. That is because the parties agree that retroactive tax collection in this case is impossible, since the tax years in question are 1978-1982, and the statute of limitations for assessment or collection of a tax deficiency is four years (§ 19057). Thus, even if section 19393 is broad enough to cover Ceridian, it cannot provide the constitutionally required relief in this case. The Board seems to recognize as much when it reminds us again that it cannot refuse to enforce the provision unless and until it has been adjudged unconstitutional (Cal. Const., art. III, § 3.5). We therefore hold that section 19393 violates a taxpayer's right to due process, where, as here, the retroactive assessment it provides cannot lawfully be collected. Accordingly, the trial court did not err by awarding Ceridian the stipulated refund.[9]

---

[9] The Board maintains that even if Ceridian cannot be denied a refund, section 19393 should be applied to taxpayers that benefited from the deduction and as to whom readjustment of tax liability is not time-barred. On the other hand, not surprisingly, amici repeatedly refer to refunds due to "Ceridian and *similarly situated* taxpayers." This is not a class action suit; only Ceridian's refund claim is before us. Accordingly, we express no general opinion regarding the appropriate remedy in other cases, nor do we address the breadth of section 19393.

2. *Section 24410: Reform or Invalidation*

"[A] court may reform – i.e., 'rewrite' – a statute in order to preserve it against invalidation under the Constitution, when we can say with confidence that (i) it is possible to reform the statute in a manner that closely effectuates policy judgments clearly articulated by the enacting body, and (ii) the enacting body would have preferred the reformed construction to invalidation of the statute." (*Kopp v. Fair Pol. Practices Com.* (1995) 11 Cal.4th 607, 660-61 [47 Cal. Rptr. 2d 108, 905 P.2d 1248] (*Kopp*).) The Board suggests reformation of section 24410 might be appropriate if *only* subdivision (a), granting a dividend deduction solely to California corporations, were invalid. However, subdivision (a), which plainly applies only to corporations "commercially domiciled" in California, is clear and unambiguous on its face. Thus, we may not divine the legislative intent from other sources. (*Pacific Gas & Electric Co. v. Public Utilities Corm.* (2000) 85 Cal. App. 4th 86, 91-92, 95-96 [102 Cal. Rptr. 2d 20].) It follows that section 24410, subdivision (a) is not subject to reformation. (85 Cal. App. 4th at pp. 91-92, 95-96.) Moreover, even if we could reform subdivision (a) it would not save the statutory scheme. The deductions thus more broadly allowed would still be calculated in accordance with a formula that we have determined violates the commerce clause. As the Board recognizes, attempting to rewrite subdivision (b) would involve us in precisely the type of judicial policymaking and encroachment on the legislative function in violation of the separation of powers doctrine, against which the *Kopp* court warned. (*Kopp, supra,* 11 Cal. 4th at p. 661.) Thus, reformation is not possible in this case.

III. CONCLUSION AND DISPOSITION

We hold that Revenue and Taxation Code section 24410 is an unconstitutional enactment in that it violates the commerce clause both by allowing a deduction for insurance subsidiary dividends only to corporations domiciled in California, and in limiting the amount of the deduction according to a formula based on the subsidiary's gross receipts, payroll and property within the state. The trial court's judgment invalidating the statute and awarding Ceridian the stipulated amount of tax refund is affirmed.

McGUINESS, P.J., and WALKER, J., concur.

A petition for a rehearing was denied January 18, 2001, and the opinion was modified to read as printed above.

---

(2)

No. 03-776

Supreme Court, U.S.
FILED
JAN 2 - 2004
OFFICE OF THE CLERK

In The
Supreme Court of the United States

FRANCHISE TAX BOARD,

Petitioner,

v.

FARMER BROS. CO.,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The Second Appellate District

REPLY BRIEF

JOHN W. DAVIES, Chief Counsel
BENJAMIN F. MILLER, Counsel, Multistate Tax Affairs
(*Counsel of Record*)
KARL W. GROSSENBACHER, Sup. Tax Counsel
CRAIG A. SWIESO, Tax Counsel
CALIFORNIA FRANCHISE TAX BOARD
Post Office Box 1720
Rancho Cordova, CA 95741-1720
(916) 845-3300 Fax: (916) 845-3648

Attorneys for Petitoner
California Franchise Tax Board

COCKLE LAW BRIEF PRINTING CO. (800) 225-6964
OR CALL COLLECT (402) 342-2831

TABLE OF CONTENTS

	Page
INTRODUCTION	1
ARGUMENT	1
A. The Doctrine of Internal Consistency Does Not Support a Finding That Section 24402 Unconstitutionally Discriminates	1
1. The Doctrine of Internal Consistency as a Tool for Analyzing Discrimination	1
2. The Doctrine of Internal Consistency Is Not Applicable to the Taxation of Dividends	4
3. The Doctrine of Internal Consistency Is Not Violated in This Case in Any Event	4
B. The Preclusion of the FTB From Presenting Evidence on the Factual Predicates of the Compensatory Defense Does Not Present Constitutional Issues	6
C. The Decision in *Ceridian* Is Distinguishable From the Instant Case	6
CONCLUSION	8

TABLE OF AUTHORITIES

Page

CASES

Am. Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987) 3

Armco Inc. v. Hardesty, 467 U.S. 638 (1984) 2

Ashland Oil, Inc. v. Carly, 497 U.S. 916 (1990) 3

Ceridian Corp. v. Franchise Tax Bd., 85 Cal.App.4th 875 (2000) 1, 6, 7, 8

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) 2

Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983) 1, 2, 5

Fulton Corp. v. Faulkner, 516 U.S. 325 (1996) 7, 8

Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980) 4

Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue, 483 U.S. 232 (1987) 3

CONSTITUTIONAL AND STATUTORY PROVISIONS

Cal. Rev. & Tax. Code § 24402 ..... 1, 5, 7

Cal. Rev. & Tax. Code § 24410 6

OTHER AUTHORITIES

C. James Judson & Susan G. Duffy, *An Opportunity Missed: Armco, Inc. v. Hardesty, A Retreat from Economic Reality in Analysis of State Taxes*, 87 W. Va. L. Rev. 723 (1985) 2

TABLE OF AUTHORITIES – Continued

Page

R.G. Lathrop, *Armco–A Narrow and Puzzling Test for Discriminatory State Taxes Under the Commerce Clause,* 63 Taxes 551 (Aug. 1985) 2, 3

INTRODUCTION

Respondent raises two new questions in its Statement of the Case and relies on a case, *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal.App.4th 875 (2000), not discussed in the Petition. Petitioner, pursuant to Rule 15.6, files this reply to address those two questions and discuss that case.

ARGUMENT

A. The Doctrine of Internal Consistency Does Not Support a Finding That Section 24402 Unconstitutionally Discriminates.

The California Court of Appeal in a single paragraph (Pet. App. 14-15), and without discussion or analysis, summarily rejected the Franchise Tax Board's ("FTB") argument that section 24402 did not violate the internal consistency doctrine. Because the compensatory tax defense saves a facially discriminatory tax, FTB chose not to address internal consistency doctrine in its petition. Respondent now having raised the issue, Petitioner will reply.

1. The Doctrine of Internal Consistency as a Tool for Analyzing Discrimination

The internal consistency test was formulated in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983), as a means of determining whether an

apportionment formula is fair.[1] The Court stated, "[An] obvious component of fairness is what might be called internal consistency – that is the formula must be such that if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed." *Id.* at 169. The Court's discussion in *Container* related internal consistency only to the question of fair apportionment.

In *Armco Inc. v. Hardesty,* 467 U.S. 638 (1984), the Court, in analyzing a West Virginia tax scheme that integrated taxes imposed on manufacturing and wholesaling by allowing a credit against the wholesaling tax for the manufacturing tax, extended the use of internal consistency to determine if the scheme was facially discriminatory. The Court acknowledged that internal consistency was a standard for fair apportionment, but went on to say, "A similar rule applies where the allegation is that a tax on its face discriminates against interstate commerce. A tax that unfairly apportions income from other States is a form of discrimination against interstate commerce." *Id.* at 644.

The use of the internal consistency doctrine as a test of discrimination in *Armco* has been criticized by commentators. See, e.g., C. James Judson & Susan G. Duffy, An Opportunity Missed: *Armco, Inc. v. Hardesty*, A Retreat from Economic Reality in Analysis of State Taxes, 87 W. Va. L. Rev. 723 (1985); R.G. Lathrop, *Armco–A Narrow and Puzzling Test for Discriminatory State Taxes Under*

[1] Fair apportionment is one of the four prongs of the *Complete Auto* test, *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977), used to determine whether a state tax is permissible under dormant commerce clause analysis. Discrimination is a separate, distinct prong.

the Commerce Clause, 63 Taxes 551 (Aug. 1985). Its use as a test of discrimination has been questioned by members of the Court, *Armco, id.* at 648 (Rehnquist, J., dissenting), *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 at 257 (1987) (Scalia, J., concurring in part and dissenting in part), *Am. Trucking Ass'ns., Inc. v. Scheiner*, 483 U.S. 266 at 303 (1987) (O'Connor, J., dissenting). The court in a *per curiam* opinion, *Ashland Oil, Inc. v. Carly*, 497 U.S. 916 (1990), indicated that its application may be limited to facial discrimination cases, *id.* at 919, and suggested that its use might be limited to confirming that a facially discriminatory tax is not actually discriminatory if it meets the requirements of internal consistency, *id.* at 920, quoting Justice O'Connor's dissent in *Am. Trucking, supra.* Understood as such, internal consistency is either only an alternative to the compensatory tax defense to show that a facially discriminatory tax is not unconstitutional, or a device to confirm that a tax that is facially discriminatory is in fact unconstitutionally discriminatory. It has never, however, been used by the Court to trump the compensatory tax defense.

Members of the Court have expressed concerns about the use of the internal consistency doctrine as a test of discrimination, and the Court has not addressed the interrelationship of the internal consistency doctrine and the compensatory tax defense. Consideration of these matters provides an additional reason for the Court to grant review in this matter.

2. The Doctrine of Internal Consistency Is Not Applicable to the Taxation of Dividends.

Internal consistency addresses the question of apportionment. It is used to determine whether there is multiple taxation of the same income or event in the hands of the same taxpayer. Multiple taxation of dividends, once in the hands of the company earning the income from which the dividends are paid, and again in the hands of the recipient of the dividends, is constitutionally permissible. E.g., *Mobil Oil Corp. v. Vermont,* 445 U.S. 425 (1980). Therefore, under this Court's decisions, the doctrine of internal consistency has no application to the taxation of dividends vis-à-vis the taxation of the dividend payor and the dividend recipient.[2]

3. The Doctrine of Internal Consistency Is Not Violated in This Case in Any Event.

Internal consistency addresses the question of apportionment. As such, it is the apportioning process involved in the dividend deduction that must be scrutinized. The method used by California to determine the deductible amount of dividends is based upon an apportionment methodology that has been approved by the United States

[2] Internal consistency does have application in considering how the recipient of the dividend is taxed on its income. A State could not, for example, tax dividend income arising from a unitary business on an unapportioned basis if received by a domiciliary and an apportioned basis if received by a nondomiciliary. If every State followed that rule, more than 100 percent of the amount of the dividend would be taxed by the States, and the requirement of internal consistency would be violated.

Supreme Court, *Container Corp. of Am., supra*. An example demonstrates that internal consistency is satisfied.

> Example: Parent corporation P is taxable in California and State A. It receives dividends from corporation S, which earns 75% of its income in California and 25% of its income in State A. The dividend is included in the apportionable income of P. Under internal consistency, it must be assumed that both California and State A have section 24402. As such, all dividends are included in income, and a deduction is allowed by each state to the extent the dividends are paid from income earned in that state. S pays a dividend of $100 to corporation P paid from its activities in California and State A. The following would occur under section 24402.

	California	State A	Total
Divided Income	$100	$100	$100[3]
24402 Deduction	$ 75	$ 25	$100
Amount in Income	$ 25	$ 75	$100

> Varying the percentages would not vary the result.

---

[3] Each state is considering the same dividend, but this does not mean $200 is being taxed. P itself would apportion the dividend income along with its other income. This step is not included in the example for the sake of simplicity since it is the pre-apportioned income that is included in the base.

B. The Preclusion of the FTB From Presenting Evidence on the Factual Predicates of the Compensatory Defense Does Not Present Constitutional Issues.

FTB, in its Petition, stated that it proffered a witness list of two professors who would testify to the presence of the factual predicates of the compensatory tax defense (Pet., p. 4), that the trial court denied the Taxpayer's Motion In Limine to exclude this testimony as moot, *id.*, filed an application for an extraordinary writ with the Court of Appeal for review of the trial court ruling on this ruling, *id.*, and that the application was denied, *id.* at 5. Evidence of the factual predicates of the compensatory tax defense is not present in this case because FTB was precluded from presenting such evidence. In any event, this procedural issue is not pertinent to, and does not impact, the necessity for the Court to grant review.

C. The Decision in *Ceridian* Is Distinguishable From the Instant Case.

Respondent cites to the California Court of Appeal's decision in *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal.App.4th 875 (2000), as a judicial authority dealing with a dividends-received deduction that is consistent with the California Court of Appeal's decision in this case. Petitioner did not discuss this case in its Petition because it has no application in the circumstances of this case.

Ceridian involved a California statute, Rev. & Tax. Code section 24410 (reproduced in relevant part in App. B to Resp. Opp., pp. 20-21, n2), that granted a dividends-received deduction to corporations commercially domiciled

in California for dividends received from an eighty-percent-or-more-owned insurance company that was paid from income arising from California sources.

The deduction in *Ceridian* suffered from a constitutional defect that is not present in this case, or in any of the other cases discussed by Respondent. The deduction was only available to corporations commercially domiciled in California. That is a facial discrimination for which the compensatory tax defense would never be an answer.

The *Ceridian* statute allows a dividends-received deduction rather than a proportionate reduction in the value of the intangibles being taxed. Therefore, disregarding the commercially domiciled defect, the statute in *Ceridian* is more similar to the statute at issue in this case than it is to the statute that was involved in *Fulton Corp. v. Faulkner,* 516 U.S. 325 (1996). But the facial similarity ends there. The deduction in *Ceridian* suffers from a second constitutional defect, the same defect as the tax in *Fulton.* In *Ceridian,* as in *Fulton,* there were two different taxes involved, measured by different bases, and assessed at different rates. FTB recognized that the Court's decision and analysis in *Fulton* was dispositive in the circumstances of *Ceridian* and, as a consequence, did not attempt a compensatory justification.

In contrast, the intrastate tax burden that section 24402 seeks to compensate for involves the same tax, imposed at the same rate, as the deduction provided to the dividend recipient by section 24402. Thus, while equivalence is not required to support a compensatory tax defense, the tax relief provided by section 24402, unlike that

in *Fulton* and *Ceridian*, is intended to, and does, provide relief that is comparable to the burden imposed.

CONCLUSION

Respondent's opposition to the granting of review may have facial appeal. Proper application of the compensatory tax defense, however, exposes the lack of substance to respondent's opposition just as the defense validates taxes that are only facially discriminatory.

Respectfully submitted,

JOHN W. DAVIES, Chief Counsel
BENJAMIN F. MILLER, Counsel,
Multistate Tax Affairs
(*Counsel of Record*)
KARL W. GROSSENBACHER,
Sup. Tax Counsel
CRAIG A. SWIESO, Tax Counsel

Attorneys for Petitioner
California Franchise Tax Board

January 2004